Supreme Court, U.S.
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No. (1)

IN THE

Supreme Court of the United States

JOHN J. MOORES, CHARLES E. NOELL, III, NORRIS VAN DEN BERG, CHRISTOPHER A. COLE, AND JMI SERVICES, INC.,
Petitioners,

v.

ROBERT C. FRIESE,
Respondent.

On Petition for a Writ of Certiorari to the Supreme Court of California

PETITION FOR A WRIT OF CERTIORARI

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QUESTIONS PRESENTED

Whether, with respect to a claim of breach of official duty to a corporation, the Commerce Clause permits a State to substitute its own substantive law for that of the State of incorporation.

Whether the Due Process Clause permits the directors and officers of a corporation incorporated in one State to be sued under the substantive law of another State for alleged breach of official duty to the corporation.

CORPORATE DISCLOSURE STATEMENT

Pursuant to Rule 29.6, Petitioner JMI Services, Inc. states that it has no parent corporation and that no publicly held company owns 10% or more of its stock.

LIST OF PARTIES

Pursuant to Rule 14.1(b), Petitioners state that the following were parties in the California Court of Appeal proceedings below, in addition to those named in the caption:

Rodney Dammeyer
Stephen P. Gardner
Matthew C. Gless
Frederic B. Luddy
Richard T. Nelson
Thomas G. Watrous

In the California Superior Court below, the following were also parties:

Richard A. Hosley II
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PETITION FOR A WRIT OF CERTIORARI

Petitioners John J. Moores, Charles E. Noell, III, Norris van den Berg, Christopher A. Cole, and JMI Services, Inc. ("Petitioners") respectfully petition for a writ of certiorari to review the judgment of the California Court of Appeal, Fourth District, Division One ("Court of Appeal").

OPINIONS BELOW

The order of the Supreme Court of California denying review of the Court of Appeal's opinion (Pet. App. 1a-2a) is unreported. The opinion of the Court of Appeal (Pet. App. 3a-26a) is reported at 36 Cal. Rptr. 3d 558 (Cal. Ct. App. 2005). The decision of the Superior Court of California, San Diego County (Pet. App. 27a-31a) is unreported.

JURISDICTION

The California Supreme Court denied Petitioners' petition for review on March 15, 2006. This Court has jurisdiction under 28 U.S.C. § 1257. Pursuant to Rule 29.4(c), Petitioner certifies that 28 U.S.C. § 2403(b) may apply and that this Petition has been served upon the Attorney General of California.

STATUTES INVOLVED

Sections 2116, 25402, and 25502.5 of the California Corporations Code are reprinted in the appendix to this petition (Pet. App. 32a-33a).

INTRODUCTION AND SUMMARY

This case arises from California's latest effort to assert nationwide regulatory authority over the internal affairs of a corporation incorporated in another State. This case involves no claim by an aggrieved investor in California, no claim by a California government official alleging injury to California markets, and no claim by a California corporation. Rather this case involves a claim by a *Delaware* corporation against its own directors and officers, alleging that they improperly traded stock based on material nonpublic information. This claim is made under California law, subject to California penalties, whether or not Delaware law would recognize such claims or provide similar penalties.

Such a claim by a corporation against its own directors and officers is a classic matter of that corporation's internal affairs. Any claim by a corporation alleging insider trading by its own directors and officers can arise only from a breach of fiduciary duty—specifically, the misuse of corporate information gained in an official capacity. Like any other matter of a corporation's internal affairs, a breach of fiduciary duty to a corporation by that corporation's own directors and officers is a matter that has long been governed solely by the law of the State of incorporation. The orderly conduct of business in the interstate marketplace has gained notable stability and certainty from this principle, often called the

"internal affairs doctrine." The decision below abrogates this venerable principle, and holds that California has the open-ended authority to apply its own law to the internal affairs of foreign corporations whenever, in its view, the "interest of justice" requires.

This ruling raises significant federal constitutional issues that warrant this Court's review. Both the Commerce Clause and the Due Process Clause restrain one State from intruding into the internal affairs of a corporation that has chosen to incorporate in another State. The Commerce Clause, by negative implication, limits the power of a State to regulate commerce outside its borders. A State has no legitimate interest under the Commerce Clause in regulating the internal affairs of an out-of-state corporation. Nor may a State burden interstate commerce by subjecting a corporation's internal governance to inconsistent regulation across state lines.

The Due Process Clause entitles the directors and officers of a corporation to have advance notice of liability they might suffer for breach of fiduciary duty. In violation of that principle, the decision below potentially subjects officers and directors of a Delaware corporation to differing liability to the corporation in any of 49 States other than Delaware, destroying the expectations they had when they agreed to serve the corporation under Delaware law. Compounding the problem, the decision below held that the internal affairs doctrine may be abrogated whenever "the interest of justice" requires. Such a principle is far too vague and open-ended to give the fair warning that due process requires.

The decision below not only sweeps aside these fundamental constitutional principles; it brings the California courts into severe tension with the Delaware Supreme Court. That court recently invalidated an effort by California to interfere with the internal affairs of Delaware corporations. Under California Corporations Code Section 2115, California purported to impose California shareholder voting rules upon

out-of-state corporations with a majority of shares held or business conducted in California. Holding that "application of the internal affairs doctrine is mandated by constitutional principles," *VantagePoint Venture Partners 1996* v. *Examen, Inc.*, 871 A.2d 1108, 1113 (Del. 2005), the Delaware Supreme Court invalidated this "quasi-California corporation" provision as applied to a Delaware corporation, *see id.* at 1115-16.

In this case, by contrast, the California courts have upheld a California law that intrudes at least as seriously into a Delaware corporation's internal affairs. At issue here is California Corporations Code Section 25502.5. As authoritatively construed by the state courts below, this statute permits a Delaware corporation to sue its own officers and directors, subject to California shareholder demand and board voting rules, for breach of internal duty to the corporation—regardless of what Delaware law might provide. This Court's intervention is warranted to resolve this deep conflict between the principles adopted by the California and Delaware state courts.

Without review by this Court, the decision below threatens serious consequences to the business community and the orderly operations of the national marketplace. The internal affairs doctrine enables corporations and their officers and directors to choose a State of incorporation based on its corporate laws and then to rely upon those laws in performing their fiduciary duties. If the decision below is allowed to stand, corporate directors and officers will be subject to different pleading standards, different standards of proof, different elements, different affirmative defenses and different damages for insider trading claims in every State. Review by this Court is necessary to prevent the uncertainty and confusion engendered by the decision below.

STATEMENT OF THE CASE

1. California's Statutory Scheme.

California's insider trading statute, enacted as part of the Corporate Securities Law of 1968, forbids an "officer, director or controlling person of an issuer" from "purchas[ing] or sell[ing] any security of the issuer in this state at a time when he knows material information about the issuer gained from such relationship which would significantly affect the market price of that security and which is not generally available to the public." Cal. Corp. Code § 25402. Like other States, California provides aggrieved buyers or sellers a civil remedy for violation of this provision. Cal. Corp. Code § 25502. It also permits the state government to sue for violation of this provision. Cal. Corp. Code §§ 25400-25404, 25530.

This case, however, is not such a suit by California investors or government officials. The California statute at issue here—Cal. Corp. Code § 25502.5—authorizes *the corporation itself* to bring insider trading suits against its own officers and directors. Enacted in 1988 as an amendment to the Corporations Code, Section 25502.5(a) provides that "[a]ny person other than the issuer who violates Section 25402 shall be liable to the issuer of the security purchased or sold in violation of Section 25402 for damages in an amount up to three times" the difference between the value of the stock with and without public knowledge of the inside information. Section 25502.5(c) goes on to set forth specific voting and quorum rules governing shareholder demands that the board consider such insider trading allegations, as well as standards of "good faith" that apply to such demands.

Section 25502.5 is unique; "no other state presently has a statutory provision making a person using inside information liable *to the issuer* of that security." Don Berger, *Issuer Recovery of Insider Trading Profits Under Section 25502.5 of the California Corporation Code*, 21 PAC. L.J. 221, 226

(1989-1990) (emphasis added). And Section 25502.5 is uniquely punitive in providing a treble damages remedy; no other State provides such a disproportionate private remedy for alleged insider trading.[1]

2. The Origins of This Case.

Peregrine Systems is a manufacturer of computer software for businesses that was reincorporated in Delaware in 1994 and headquartered in San Diego, California until December 2005. Peregrine's directors included Petitioners John Moores, Charles Noell, Norris van den Berg, and Christopher Cole.

Peregrine's Articles of Incorporation provided at all relevant times that rights and liabilities pertaining to corporate governance matters would be controlled by Delaware law and that Delaware law would define the scope of its directors' liability to the corporation.[2] Peregrine also invoked Delaware

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[1] Federal law likewise is nowhere near as sweeping as California's. Under the closest federal analogues to section 25402—section 10(b) of the Securities Exchange Act and SEC Rule 10b-5—corporations may *not* sue their officers or directors for insider trading involving third parties (much less sue them for treble damages) because the federal cause of action requires proof of reliance by, and actual harm to, the plaintiff. *See Basic Inc.* v. *Levinson*, 485 U.S. 224, 243 (1988) ("We agree that reliance is an element of a Rule 10b-5 cause of action . . . [because it] provides the requisite causal connection between a defendant's misrepresentation and a plaintiff's injury."); *see also Reliance Elec. Co.* v. *Emerson Elec. Co.*, 404 U.S. 418, 422 (1972) (describing section 16(b) of the Act, 15 U.S.C. § 78p(b), which requires officers and directors to disgorge profits made on the sale of securities held for less than six months, as "the only method Congress deemed effective to curb the evils of insider trading").

[2] *See* Peregrine's Form S-1/A, filed March 17, 1997, at 46, *available at* http://www.sec.gov/Archives/edgar/data/1031107/0000912057-97-008972.txt ("The Company has adopted provisions in its Amended and Restated Certificate of Incorporation that eliminate to the fullest extent permissible under Delaware law the liability of its directors to the Company for monetary damages.").

law when it induced its directors to join and to continue to serve on its board.[3]

In May 2002, Peregrine announced that it had overstated earnings in past years as a result of accounting irregularities, and the company's share price fell sharply. Four months later, Peregrine initiated reorganization proceedings in the United States Bankruptcy Court for the District of Delaware. Although Peregrine's internal investigation of the accounting irregularities expressly absolved Petitioners and the other outside directors of any wrongdoing,[4] some shareholders brought federal class action suits against Peregrine and its outside directors under section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b), and Securities Exchange Act Rule 10b-5, 17 C.F.R. § 240.10b-5, alleging that there had been trading on inside information before Peregrine disclosed its accounting irregularities to the public. In November 2003, the federal district court dismissed all 10b-5 claims against the directors for failure to state a claim. *In re Peregrine Sys., Inc., Sec. Litig.*, No. 02 CV 870-J(RBB) (S.D. Cal. Nov. 23, 2003).

Three months later, in February 2004, Robert C. Friese, the trustee of a Litigation Trust established in Peregrine's bankruptcy and controlled by the federal class action plaintiffs, filed claims assigned to the Litigation Trust by Peregrine in

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[3] *See* Form of Indemnification Agreement, Exhibit 10.7 to Peregrine's Form S-1, filed February 10, 1997, *available at* http://www.sec.gov/Archives/edgar/data/1031107/0000912057-97-003853.txt.

[4] *See* Latham & Watkins Report of Investigation, filed August 9, 2004 in San Diego Superior Court Case No. GIC 788659, at 116 ("There is no evidence that any Outside Director had knowledge of unlawful conduct or serious accounting irregularities before KPMG requested a meeting with the Audit Committee outside the presence of management in April 2002 . . . . Even with the benefit of hindsight, there is no basis to assign blame to the Outside Directors for Peregrine's accounting or disclosure problems.").

California state court against Petitioners and other former Peregrine directors and officers. Among other causes of action, the Litigation Trust (hereinafter "Peregrine") alleged that the Petitioners were liable to the corporation under California Corporations Code § 25502.5. It is undisputed that the only claims asserted in this state action were Peregrine's own claims against its former directors and officers, which Peregrine chose to pursue under California rather than Delaware law.[5]

3. The Proceedings Below.

Petitioners and the other defendants moved to dismiss the state lawsuit, including Peregrine's Section 25502.5 claims, arguing that Delaware law, not California law, must be applied to any insider trading claim by Peregrine against its own directors and officers. The trial court agreed, dismissing the suit on the grounds that "Delaware law governs the relationship between Peregrine and its directors and/or officers" and that plaintiffs had claimed "violations of [California] statutes this Court finds to be not applicable." Pet. App. 29a.

The California Court of Appeal, however, granted Peregrine's petition for a peremptory writ of mandate and vacated the trial court's dismissal in a decision filed December 2, 2005 (Pet. App. 5a-26a), and amended December 29, 2005 (Pet. App. 4a), and January 24, 2006 (Pet. App. 3a). The Court of Appeal construed Section 25502.5, for the first time since its enactment, as extending beyond California corporations and permitting treble-damage insider trading claims

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[5] It is unclear whether Delaware law currently enables a corporation to sue officers and directors for insider trading at all, but if such a claim were permitted, it would require proof of well-defined elements and would not result in any punitive treble damage remedy. *See In re Oracle Corp.*, 867 A.2d 904, 926-34 (Del. Ch. 2004), *aff'd sub nom. In re Oracle Corp. Derivative Litig.*, 872 A.2d 960 (Del. 2005).

even by out-of-state corporations against their own directors and officers. (*See* Pet. App. 24a).

The Court of Appeal rejected the argument that Peregrine's insider trading claims against its own directors and officers are matters of internal affairs subject solely to Delaware law. First, the court noted that Section 25502.5 is "part of California's corporate securities regulation scheme" (Pet. App. 26a), and sought to analogize it to state blue-sky laws protecting California investors (Pet. App. 12a-15a, 21a-23a), even though this case involves no claim by any investor who purchased or sold securities.

Second, the court below held that California may make whatever exceptions to the internal affairs doctrine it chooses "'in the interest of justice.'" (Pet. App. 22a (quoting 9 WITKIN, SUMMARY OF CAL. LAW, CORPORATIONS, § 239 at 1006 (10th ed. 2005))). The court below accepted that Section 25502.5 regulates the internal relationship between a corporation and its own directors and officers, but held that it is "not . . . *merely* a device for enforcing directors' and officers' fiduciary duties." (Pet. App. 25a (emphasis added)). In the view of the court below, Section 25502.5 also serves as a "means of punishing what is perceived by the public as immoral conduct." (Pet. App. 25a). It thus concluded that the internal affairs doctrine may be abrogated and an out-of-state corporation deputized to pursue California's own public policy interests: "'the absence of monetary injury to the issuer of the traded security is less important than the *deterrent* of insider trading.'" (Pet. App. 19a (quoting Berger, *supra*, at 226)).

The Court of Appeal ignored Petitioners' arguments, preserved below (*see* Pet. App. 34a-35a) and presented at length in their appellate briefs (*see* Pet. App. 36a-48a), that the dormant Commerce Clause and Due Process Clause forbid such an abrogation of the internal affairs doctrine.

Over the dissents of two Justices, the California Supreme Court denied the officers' and directors' petition for review (Pet. App. 1a), which again raised both Commerce Clause and Due Process Clause objections (Pet. App. 49a-52a).

The decision of the intermediate appellate court below thus represents an authoritative construction of Section 25502.5 as enabling an out-of-state corporation to pursue a cause of action against its own directors and officers for breach of official duty to the corporation.

REASONS FOR GRANTING THE PETITION

This Court should grant certiorari to resolve the severe tension between decisions of the Delaware and California courts concerning the scope of California's power, consistent with the federal Constitution, to regulate the internal affairs of a Delaware corporation. The decision below poses a significant threat to the orderly conduct of corporate business between the Nation's most populous State and its leading State of incorporation. And the decision below provides a good vehicle for resolving this conflict, as it presents a clean question of law that requires no further state-law development: whether the Commerce Clause and the Due Process Clause permit California to interpret its corporations code to abrogate, in "the interest of justice," the longstanding rule that an out-of-state corporation's internal affairs are to be determined solely by the law of the State of incorporation.

Contrary to the decision below, which wholly ignored Petitioners' extensively briefed federal constitutional arguments, the internal affairs doctrine is a federal constitutional requirement, not a discretionary choice-of-law principle that States may disregard whenever they conclude that "the interest of justice" so warrants. As the Delaware Supreme Court has reiterated, both the Commerce Clause and the Due Process Clause bar a State from reaching across state lines to tell an out-of-state corporation how to order relationships

among the corporation and its directors, officers and shareholders. Just as California may not deem a Delaware corporation with a certain volume of business in California a "quasi-California corporation" subject to California corporate governance law, California may not deputize a Delaware corporation to pursue California's own idiosyncratic state-law objectives by suing its own directors and officers for breach of official duty.

Certiorari is warranted as well to limit the disruptive effects of the decision below upon the business community. The California courts have opened the door to a conflicting patchwork of claims concerning directors' and officers' fiduciary obligations to the corporations they serve. Under the decision below, a Delaware corporate director or officer might be subject to one pleading standard, standard of proof, and set of elements, affirmative defenses and damages in Delaware and another in California for the same underlying conduct. Such potentially conflicting liability unsettles the long-settled order that the internal affairs doctrine has brought to the conduct of interstate business.

I. THE DECISION OF THE CALIFORNIA COURTS BELOW CONFLICTS WITH DECISIONS OF THE DELAWARE SUPREME COURT HOLDING THAT THE FEDERAL CONSTITUTION BARS CALIFORNIA FROM REGULATING THE INTERNAL AFFAIRS OF DELAWARE CORPORATIONS

As the Delaware Supreme Court has observed, "the conflicts practice of both state and federal courts has consistently been to apply the law of the state of incorporation to the entire gamut of internal corporate affairs." *VantagePoint Venture Partners 1996* v. *Examen, Inc.*, 871 A.2d 1108, 1113 (Del. 2005) (internal quotation marks omitted). As that court earlier explained: "Corporations and individuals alike enter into contracts, commit torts, and deal in personal and real

property. . . . The internal affairs doctrine . . . governs the choice of law determinations involving matters *peculiar* to corporations, that is, those activities concerning the relationships *inter se* of the corporation, its directors, officers and shareholders." *McDermott Inc.* v. *Lewis*, 531 A.2d 206, 214-15 (Del. 1987) (citation omitted). And as that court likewise has repeatedly stated, "application of the internal affairs doctrine is not merely a principle of conflicts law," but "also one of serious constitutional proportions—under due process, the commerce clause and the full faith and credit clause[.]" *Id.* at 216.

Most recently, the Delaware Supreme Court restated these principles as follows:

> Pursuant to the Fourteenth Amendment Due Process Clause, directors and officers of corporations have a significant right . . . to know what law will be applied to their actions and stockholders . . . have a right to know by what standards of accountability they may hold those managing the corporation's business and affairs. Under the Commerce Clause, a state has no interest in regulating the internal affairs of foreign corporations. Therefore, this Court has held that an application of the internal affairs doctrine is mandated by constitutional principles, except in the rarest situations, *e.g.*, when the law of the state of incorporation is inconsistent with a national policy on foreign or interstate commerce.

VantagePoint, 871 A.2d at 1113 (footnotes and internal quotation marks omitted).[6]

Following these federal constitutional principles, the Delaware Supreme Court in *VantagePoint* invalidated a provision of the California Corporations Code that purported to apply

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[6] The latter exception is inapplicable here; there is no claim here that Delaware corporate law is in any way inconsistent with national policy. *See supra* note 1.

California's shareholder class voting rules to Delaware corporations that do significant business in California. *See* Cal. Corp. Code § 2115. Specifically, the California Corporations Code provided that a merger had to be approved by each shareholder class voting separately, whereas the Delaware General Corporation Law provided for approval by outstanding shares of all classes voting together on an as-converted basis. The Delaware Supreme Court held that the Delaware shareholder class voting rules must apply to a Delaware corporation regardless of the volume of business it does in California. It thus rejected the notion that California could project its views of proper corporate governance structure into the internal affairs of a Delaware corporation.

Although the decision below involves a different provision of the California Corporations Code—one to which the Delaware courts have not directly spoken—it rests on a principle that is directly opposed to the one established in *VantagePoint*. The decision below, contrary to *VantagePoint*, holds that California may indeed intrude into the "relationships *inter se* of [a] corporation, its directors, officers and shareholders" in order to serve its own state law objectives. The court below interpreted Section 25502.5—as the Delaware Supreme Court did Section 2115—as governing a Delaware corporation's internal affairs. The court below simply held—unlike the Delaware Supreme Court with respect to Section 2115—that such intrusion was permissible "in the interest of justice" to further California's own idiosyncratic substantive law objectives.

The decision below thus conflicts with *VantagePoint* with respect to interpretation of the Commerce and Due Process clauses; Delaware reads the federal Constitution to limit California's efforts to regulate the internal affairs of Delaware corporations whereas California does not.

Because certiorari was not sought from *VantagePoint*, the question presented here is before this Court for the first time.

The decision below is a good vehicle for resolving it. The decision below, after denial of review by the California Supreme Court, represents a now-authoritative construction of California law permitting a Delaware corporation to sue its own officers and directors for breach of internal fiduciary duty. For the reasons that follow, this decision should be found unconstitutional.

A. As Delaware Has Correctly Held, Contrary to the Decision Below, the Commerce Clause Bars a State from Regulating the Internal Affairs of an Out-of-State Corporation

The Commerce Clause provides that "[t]he Congress shall have Power . . . [t]o regulate Commerce . . . among the several States." U.S. Const., art. I, § 8, cl. 3. It is well settled that, in addition to vesting this specific authority in Congress, the Commerce Clause also has a negative, or "dormant," aspect that "even without implementing legislation by Congress is a limitation upon the power of the States." *Edgar* v. *MITE Corp.*, 457 U.S. 624, 640 (1982) (plurality opinion) (quoting *Great Atl. & Pac. Tea Co.* v. *Cottrell*, 424 U.S. 366, 370-71 (1976)).

Among these limitations is a prohibition on one State's regulation of the internal affairs of a corporation incorporated in another State. "The internal affairs doctrine is a conflict of laws principle which recognizes that only one State should have the authority to regulate a corporation's internal affairs—matters peculiar to the relationships among or between the corporation and its current officers, directors, and shareholders." *Edgar v. MITE*, 457 U.S. at 645. That "one State," this Court has held, is the State of incorporation. *See First Nat'l City Bank* v. *Banco Para El Comercio Exterior de Cuba*, 462 U.S. 611, 621 (1983).

The Commerce Clause is violated in three distinct ways when one State interferes in the internal affairs of a corpora-

tion incorporated in another State by altering the law that applies to a corporation's suit against its own directors and officers.

First, and most fundamental, the Commerce Clause bars a State from regulating commerce outside of that State's borders, even if the commerce has effects within that State. In *Southern Pacific Co.* v. *Arizona*, 325 U.S. 761 (1945), for example, the Court struck down on Commerce Clause grounds a state law where the "practical effect of such regulation is to control [conduct] beyond the boundaries of the state." *Id.* at 775. As this Court has noted, the Commerce Clause "limits on a State's power to enact substantive legislation are similar to the limits on the jurisdiction of state courts. In either case, 'any attempt "directly" to assert extraterritorial jurisdiction over persons or property would offend sister States and exceed the inherent limits of the State's power.'" *Edgar v. MITE*, 457 U.S. at 643 (quoting *Shaffer* v. *Heitner*, 433 U.S. 186, 197 (1977)); *cf. Healy* v. *Beer Institute*, 491 U.S. 324, 337-38 (1989) (invalidating a State's extraterritorial regulation of beer prices). California's effort to provide the rule of decision for claims by a corporation that has incorporated in Delaware under Delaware law against its own directors and officers amounts to such extraterritorial regulation.

Second, although the Commerce Clause permits States to regulate interstate commerce incidentally, "direct regulation is prohibited." *Edgar v. MITE*, 457 U.S. at 640. In *Edgar*, this Court held that an Illinois tender-offer law violated the Commerce Clause because it "directly regulates transactions which take place across state lines, even if wholly outside the State of Illinois," since a tender offer for securities of a publicly held corporation is communicated through means of interstate commerce and the takeover is an interstate transaction. *Id.* at 641. A State law likewise directly burdens interstate commerce when it purports to legislate the remedies

of an out-of-state corporation against its own directors and officers, who may not be California residents, for trading shares on a national exchange with persons who may not be California residents, as long as the offer to trade "originated from California." *See* Cal. Corp. Code § 25008 (defining purchase and sale of a security).

Third, the Commerce Clause bars a State from burdening interstate commerce indirectly "by subjecting activities to inconsistent regulations." *CTS Corp.* v. *Dynamics Corp.*, 481 U.S. 69, 88 (1987). The decision below imposes such a burden by reading California law so as to "create an impermissible risk of inconsistent regulation by different States." *Id.* at 89-90. Nor is such a burden justified by a legitimate local interest. *See Pike* v. *Bruce Church, Inc.*, 397 U.S. 137, 142 (1970) (holding that state laws may not indirectly burden interstate commerce unless outweighed by a legitimate local interest). Because States "ha[ve] no interest in regulating the internal affairs of foreign corporations," state laws purporting to do so violate the Commerce Clause. *Edgar v. MITE*, 457 U.S. at 645-46.

The internal affairs doctrine serves the Nation's keen interest, expressed in the Commerce Clause, in avoiding a patchwork of inconsistent state regulations under which corporate actors cross state lines at their peril. Our "beneficial free market system depends at its core upon the fact that a corporation—except in the rarest situations—is organized under, and governed by, the law of a single jurisdiction, traditionally the corporate law of the State of its incorporation." *CTS Corp.*, 481 U.S. at 90. Such uniform treatment is necessary to meet "the need for certainty and predictability of result while generally protecting the justified expectations of

parties with interests in the corporation." *First Nat'l City Bank*, 462 U.S. at 621.[7]

Like the Delaware Supreme Court, a number of federal circuits have also recognized that, under this Court's Commerce Clause precedents, the internal affairs doctrine prohibits States from regulating the internal affairs of out-of-state corporations. For example, Judge Easterbrook, writing for the Seventh Circuit, has explained that under *CTS Corp.* and *Edgar v. MITE*, "the liability of corporate investors and directors for intra-corporate affairs almost invariably depends on the law of the place of incorporation." *Nagy* v. *Riblet Prods. Corp.*, 79 F.3d 572, 576 (7th Cir. 1996) (certifying question to Delaware Supreme Court regarding scope of fiduciary duty majority shareholders have to minority shareholders). That conclusion, he added, is necessary for the sound administration of U.S. corporate law: "A single rule for each corporation's internal affairs reduces uncertainty and the prospect of inconsistent obligations; it also enables the corporate venturers to adjust the many variables of corporate life (including the contractual promises made to CEOs), confident that they can predict the legal effect of these choices." *Id.*; *see Batchelder* v. *Kawamoto*, 147 F.3d 915,

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[7] *See also Kamen* v. *Kemper Fin. Servs., Inc.*, 500 U.S. 90, 106 (1991) ("'Uniform treatment of directors, officers and shareholders is an important objective which can only be attained by having the rights and liabilities of those persons with respect to the corporation governed by a single law.'" (citing RESTATEMENT (SECOND) CONFLICT OF LAWS § 302)); *Cort* v. *Ash*, 422 U.S. 66, 84 (1975) ("Corporations are creatures of state law, and investors commit their funds to corporate directors on the understanding that, except where federal law expressly requires certain responsibilities of directors with respect to stockholders, state law will govern the internal affairs of the corporation."); *cf. Rogers* v. *Guaranty Trust Co.*, 288 U.S. 123, 130 (1933) ("It has long been settled doctrine that a court—state or federal—sitting in one state will, as a general rule, decline to interfere with, or control by injunction or otherwise, the management of the . . . corporation organized under the laws of another state.").

920 (9th Cir. 1998) (citing *CTS Corp.* and holding that double derivative claims must be evaluated under Japanese law); *Hyde Park Partners, L.P.* v. *Connolly*, 839 F.2d 837, 843-48 (1st Cir. 1988) (discussing *CTS Corp.* and *Edgar v. MITE*).

In conflict with all of these decisions, the Court of Appeal held below that, whenever a California court perceives a need to vindicate some California state law interest, it "may, in the interest of justice, take jurisdiction over internal affairs and apply the local law." Pet. App. 22a (internal quotation marks omitted). The court cited no basis in constitutional law for that sweeping and open-ended abrogation of the internal affairs doctrine, and there is none.

The court sought to justify this holding on two grounds, both untenable. First, it suggested that, because of its location in the California Corporations Code, Section 25502.5 must be analogous to state "blue-sky laws." Pet. App. 22a, 24a-25a. Blue-sky laws, however, govern the sale of securities to investors in securities markets—matters entirely external to the corporation.[8] Section 25502.5, by contrast, is not a blue-sky law, but a regulation of a corporation's *internal* affairs, relating to the liability of corporate officers and directors to the corporation itself.[9] Section 25502.5 cannot be a

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[8] *See Fulton Corp.* v. *Faulkner*, 516 U.S. 325, 336 (1996) (characterizing blue-sky laws enacted in "most States" as "prescrib[ing] who may sell securities . . . , the procedures that must be followed to do so, and the fees imposed for the privilege"); *see also Edgar v. MITE*, 457 U.S. at 641 (explaining that basis for prior cases upholding constitutionality of blue-sky laws was that those laws "only regulated transactions occurring within the regulating States").

[9] *See* RESTATEMENT (SECOND) CONFLICT OF LAWS § 309 & cmt. a (noting that, as a general rule, "[t]he local law of the state of incorporation will be applied to determine the existence and extent of *a director's or officer's liability to the corporation*, its creditors and shareholders," including "[l]iability . . . for such matters as the *fraudulent mismanagement* of the corporation's affairs" (emphasis added)); *In re Sagent Tech., Inc., Derivative Litig.*, 278 F. Supp. 2d 1079, 1092 (N.D. Cal. 2003) (holding,

blue-sky law merely because of its placement in the state code. Under that reasoning, California could enact any law governing the fiduciary duties of directors and officers of an out-of state-corporation so long as it included it in the securities section of the Corporations Code. Nor can it be a blue-sky law merely because it involves securities, since any breach of fiduciary duty might affect the value of a corporation's securities in the securities market. While the Commerce Clause is not offended when a State sets forth blue-sky laws for the marketing of securities by an out-of-state corporation within its borders, it is offended when a State reaches across its borders to intercede in the relationship between an out-of-state corporation and its own directors and officers.

Second, the court below suggested that California's zealous pursuit of insider trading can somehow trump the national interest in maintaining a single source of law to govern the relationship between a corporation and its directors. *See* Pet. App. 25a-26a. But state law policies may not trump federal constitutional law principles, and States "ha[ve] no interest in regulating the internal affairs of foreign corporations" in any event. *Edgar v. MITE*, 457 U.S. at 645-46.

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contrary to the decision below, that an insider trading claim under California law must fail under the internal affairs doctrine because "there *is* an 'official duty' at issue," namely, "the fiduciary duty owed by officers and directors of a corporation to that corporation and its shareholders"); *Diamond* v. *Oreamuno*, 248 N.E.2d 910, 913 (N.Y. 1969) (grounding a corporation's right to sue its directors for insider trading in the fiduciary duty owed by the directors to the corporation).

If there remained any doubt that Section 25502.5 intrudes directly into the internal corporate affairs of out-of-stock corporations, it is resolved by considering subsection (c) of that provision. Section 25502.5 (c) requires every corporation's board of directors to consider, under California-law standards of "good faith," any insider trading allegation by "any shareholder," and purports to establish quorum and voting requirements with respect to such allegations. Cal. Corp. Code § 25502.5(c) (Pet. App. 33a).

California is of course free to pursue its unusually aggressive campaign against insider trading through any number of other mechanisms, including those already included in its Corporations Code. *See* Cal. Corp. Code §§ 25500-25502, 25504 (allowing insider trading claims by California investors claiming injury); Cal. Corp. Code §§ 25400-25404, 25530 (allowing the State Commissioner to bring enforcement actions against insider trading in California); *see* Cal. Corp. Code §§ 25540-25542 (criminal provisions against insider trading). What is at issue here is whether California may abrogate the internal affairs doctrine by permitting an out-of-state corporation to sue its own directors and officers for conduct in their official capacities in order to promote California's "broad public interests." This abrogation of the internal affairs doctrine should be invalidated under the dormant Commerce Clause.

B. As Delaware Has Correctly Held, Contrary to the Decision Below, Due Process Entitles Directors and Officers of a Delaware Corporation to Rely upon the Expectation that Their Relationship to the Delaware Corporation Will Be Governed by Delaware, Not California, Law

In proper keeping with this Court's precedents, the Delaware Supreme Court has held that the internal affairs doctrine is rooted in due process principles as well as in principles of federalism. "[D]irectors and officers have a significant right, under the fourteenth amendment's due process clause, to know what law will be applied to their actions," and shareholders "also have a right to know by what standards of accountability they may hold those managing the corporation's business and affairs." *McDermott Inc.*, 531 A.2d at 217.

Throughout the modern corporate governance era, directors and officers have undertaken fiduciary duties to the corporations they serve under the law of the State of incorporation—

not under a shifting patchwork of other States' laws. Assured by Peregrine that Delaware law would govern their relationship, the Petitioners here undertook their own obligations to Peregrine under the corporate governance laws of the State of Delaware. *See supra* pp. 6-7. They could not possibly have anticipated the novel California liability to which the decision below subjected them. For nearly 20 years, Section 25502.5 has sat on California's statute books without the California courts ever approving its application to an out-of-state corporation until now. The decision below thus violates Petitioners' "significant right, under the fourteenth amendment's due process clause, to know what law will be applied to their actions." *McDermott, Inc.*, 531 A.2d at 216.

The decision below compounds this due process violation by relying upon a standard as undefined and limitless as the "interest of justice" as a basis for abrogating the internal affairs doctrine. Application of a law is invalid if its contours are so vague that "persons of common intelligence must necessarily guess at its meaning and differ as to its application." *Connally* v. *General Constr. Co.*, 269 U.S. 385, 391 (1926). Liability under our system of laws is not supposed to be a matter of guesswork.

If California is free to abrogate the well-settled internal affairs doctrine any time it deems the "interest of justice" to require as much, potential defendants can have no advance warning of the likelihood or scope of their liabilities. Such *ad hoc* imposition of unexpected and potentially massive liability, which might be different and cumulative in any of 49 states, is inconsistent with the rule of law. As three Justices of this Court wrote in the context of punitive civil damages liability, "[r]equiring the application of law, rather than a decisionmaker's caprice, does more than simply provide citizens notice of what actions may subject them to punishment; it also helps to assure the uniform general treatment of similarly situated persons that is the essence of law itself." *BMW*

of North America, Inc. v. *Gore*, 517 U.S. 559, 587 (1996) (Breyer, J., concurring).

II. THE DECISION BELOW UNDERMINES THE CERTAINTY AND PREDICTABILITY THAT THE INTERNAL AFFAIRS DOCTRINE HAS LONG PROVIDED TO INTERSTATE BUSINESS TRANSACTIONS

The decision below is immensely consequential for the business community. "It is . . . an accepted part of the business landscape in this country for States to create corporations, to define their powers, and to define the rights that are acquired by purchasing their shares." *CTS Corp.*, 481 U.S. at 91. As one commentator has noted, the "*lex incorporationis* . . . validates the autonomy of the parties in a subject where the underlying policy of the law is enabling," thereby "facilitat[ing] planning and enhanc[ing] predictability" in the corporate governance setting. P. John Kozyris, *Corporate Wars and Choice of Law*, 1985 DUKE L.J. 1, 98.

Indeed, variations among the corporate law principles of the various States have created a legal marketplace for incorporation, in which each State encourages businesses to incorporate in its jurisdiction. One of the primary enticements a State can offer to businesses in this marketplace is a mature, well-defined corporate law that gives businesses reasonable certainty about the rules that will govern the business's affairs. *Nagy*, 79 F.3d at 576. ("States compete to provide better rules of corporate law, from which entrepreneurs may choose."). Many large American businesses have made decisions about where to incorporate with an eye towards ensuring the predictability in corporate governance that particular States offer. In particular, businesses like Peregrine "incorporate in Delaware in order to take advantage of that state's corporation law, and its judicial expertise concerning corporate governance, rather than to conduct

business there." *Curtis 1000, Inc.* v. *Youngblade*, 878 F. Supp. 1224, 1254 (N.D. Iowa 1995).

If California and other States subject officers and directors of Delaware corporations to liability rules that Delaware does not recognize, they will unsettle the "stable relationships among [corporate] parties involved" that Delaware law seeks to foster. *CTS Corp.*, 481 U.S. at 91. Indeed, because the decision below permits California courts to override the internal affairs doctrine whenever they conclude that doing so would further "the interest of justice," Pet. App. 22a, it opens the door to highly fact-specific disputes in a variety of contexts concerning which law will govern the relationships between foreign corporations and their officers and directors—precisely the type of *ad hoc* choice-of-law determinations that the internal affairs doctrine is designed to prevent. *See VantagePoint*, 871 A.2d at 1115 ("To require a factual determination to decide which of two competing state laws governs the internal affairs of the corporation at any point in time, completely contravenes the importance of stability within inter-corporate relationships that the United States Supreme Court recognized in *CTS*."). This Court's review in this case is warranted to prevent these highly destabilizing effects on interstate business transactions.

CONCLUSION

The petition for writ of certiorari should be granted.

Respectfully submitted,

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June 12, 2006

APPENDIX

APPENDIX A

Court Of Appeal, Fourth Appellate District,
Division One No. D046348
IN THE SUPREME COURT OF CALIFORNIA

[Filed Apr. 13, 2006]

En Banc

S141028

ROBERT C. FRIESE, as Trustee, etc.,
Petitioner,

v.

SAN DIEGO COUNTY SUPERIOR COURT,
Respondent;

JOHN J. MOORES *et al.*, Real Parties in Interest.

The order filed on March 15, 2006, denying the petition for review, is amended to read, in its entirety:

"Petition for review DENIED.

Kennard and Baxter, JJ., are of the opinion the petition should be granted.

George, C.J., was absent and did not participate."

/s/ Moreno
Acting Chief Justice

APPENDIX B

Court Of Appeal, Fourth Appellate District,
Division One No. D046348
IN THE SUPREME COURT OF CALIFORNIA

[Filed Mar. 15, 2006]

En Banc

S141028

ROBERT C. FRIESE, as Trustee, etc.,
Petitioner,

v.

SAN DIEGO COUNTY SUPERIOR COURT,
Respondent;

JOHN J. MOORES *et al.*, Real Parties in Interest.

Petition for review DENIED.

Kennard and Baxter, JJ., are of the opinion the petition should be granted.

George, C.J., was absent and did not participate.

/s/ Moreno
Acting Chief Justice

APPENDIX C

CERTIFIED FOR PUBLICATION

STATE OF CALIFORNIA
COURT OF APPEAL, FOURTH APPELLATE DISTRICT
DIVISION ONE

[Filed Jan. 24, 2006]

D046348
(San Diego County
Super. Ct. No. GIC788659)

ROBERT C. FRIESE, as Trustee,
Petitioner,

v.

THE SUPERIOR COURT OF SAN DIEGO COUNTY,
Respondent;

JOHN J. MOORES *et al.*, Real Parties in Interest.

[NO CHANGE IN JUDGMENT]

THE COURT:

On its own motion the court modifies the opinion filed December 2, 2005, as modified on December 29, 2005, as follows:

At the last sentence of the last paragraph of DISCUSSION IV, beginning with "The only reported case" and ending with "issued by domestic corporations" (slip opn., pp. 21-22), delete the footnote 7 reference and delete the footnote 7 text.

There is no change in the judgment.

/s/ Benke
BENKE, Acting P.J.

Copies to: All parties

APPENDIX D

CERTIFIED FOR PUBLICATION

STATE OF CALIFORNIA
COURT OF APPEAL, FOURTH APPELLATE DISTRICT
DIVISION ONE

[Filed Dec. 29, 2005]

D046348
(San Diego County
Super. Ct. No. GIC788659)

ROBERT C. FRIESE, as Trustee,
Petitioner,

v.

THE SUPERIOR COURT OF SAN DIEGO COUNTY,
Respondent;

JOHN J. MOORES *et al.*, Real Parties in Interest.

[CHANGE IN JUDGMENT]

THE COURT:

The opinion filed December 2, 2005, is modified as follows:

At the last paragraph of the opinion (disposition, slip opn., p. 25), replace the phrase "enter an order overruling the demurrers to the insider trading claims" with the phrase "conduct further proceedings consistent with the views we have expressed."

The petition for rehearing is denied.

There is a change in the judgment.

/s/ Benke
BENKE, Acting P. J.

Copies to: All parties

APPENDIX E

CERTIFIED FOR PUBLICATION

STATE OF CALIFORNIA
COURT OF APPEAL, FOURTH, APPELLATE DISTRICT
DIVISION ONE

[Filed Dec. 2, 2005]

D046348
(San Diego County
Super. Ct. No. GIC788659)

ROBERT C. FRIESE, as Trustee,
Petitioner,

v.

THE SUPERIOR COURT OF SAN DIEGO COUNTY,
Respondent;

JOHN J. MOORES et al., Real Parties in Interest.

Proceedings in mandate after superior court sustained demurrers without leave to amend. Joan M. Lewis, Judge. Petition granted.

Mazzarella, Dunwoody & Caldarelli, Mark C. Mazzarella and Marisa Janine-Page; Yetter & Warden and R. Paul Yetter for Petitioner Robert C. Friese.

No appearance for Respondent.

Post, Kirby, Noonan & Sweat and David J. Noonan; Niddrie, Fish & Buchanan and David A. Niddrie; Quinn, Emanuel, Urquhart, Oliver & Hedges, John B. Quinn, Kathleen M. Sullivan and Harry A. Olivar, Jr., for Real Parties in Interest John J. Moores and JMI Services, Inc.

Bewley, Lassleben & Miller and Leighton M. Anderson for Real Party in Interest Christopher A. Cole.

Hahn & Adema, Jane Hahn and Alison P. Adema; Goodwin Procter, Christine S. Chung and Brian E. Pastuszenski for Real Parties in Interest Norris Van Den Berg and Charles E. Noell.

Duckor, Spradling & Metzger, Michael Duckor and Robert M. Shaughnessy for Real Party in Interest Rod Dammeyer.

Bergeson, Daniel J. Bergeson, Stephen D. Rockwell, Caroline McIntyre and Derek H. Lim for Real Party in Interest Stephen P. Gardner.

Goodin, MacBride, Squeri, Ritchie & Day, Wayne Travers Lamprey, Anne H. Hartman and Glenn M. Coffin for Real Party in Interest Thomas G. Watrous.

Vance, Blair & Grady and Thomas L. Vance for Real Party in Interest Matthew C. Gless.

McKenna, Long & Aldridge, Robert S. Brewer, Jr., and Christian D. Humphreys for Real Party in Interest Richard T. Nelson.

Paul, Hastings, Janofsky & Walker and Christopher H. McGrath for Real Party in Interest Frederic B. Luddy.

Office of the State Attorney General, Bill Lockyer, Attorney General, Thomas Greene, Chief Assistant Attorney General, Mark J. Breckler Senior Assistant Attorney General, and Jeffrey A. Rich, Deputy Attorney General, Amicus Curiae for Petitioner Attorney General of the State of California.

Leck & Associates and Robert Burns Leck, Amicus Curiae for Respondent California Manufacturers & Technology Association.

Allan S. Zaremberg, Amicus Curiae for Respondent California Chamber of Commerce and California Business Roundtable.

Corporations Code[1] sections 25402 and 25502.5 are part of the Corporate Securities Law of 1968. In general, section 25402 prohibits so-called "insider trading" by the issuer of securities or by any person who is an officer, director or controlling person of an issuer. Until 1988 only purchasers or sellers of stock who could show that they had been harmed by virtue of insider trading had a right of action against violators of section 25402. In 1988 the Legislature added section 25502.5, which allows the issuer or anyone acting in the name of the issuer to recover from an officer, director or controlling person who has violated section 25402 up to three times the amount such a violator earned by virtue of his or her insider trading. Section 25502.5 is a disgorgement statute and the issuer does not need to show that it was harmed by the activities of the inside trader.

Section 25402 governs only securities transactions which occur in this state. Moreover, only issuers who have more than $1 million in assets and more than 500 shareholders may bring an action under section 25502.5. However, aside from those geographic and capitalization requirements, there are no other express limitations on the scope of either statute. In particular, nothing on the face of either statute limits application of the statutes to securities issued by domestic corporations.

Section 2116, which is not a part of the Corporate Securities Law of 1968, provides that a director's liability to a corporation is a matter of internal governance of the corporation and is governed by the laws of the state in which it is incorporated.

Here the plaintiff is the successor in interest to a Delaware corporation, which has its headquarters and principal place of business in California and does substantial business here. The defendants are a group of former officers and directors of the

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[1] All further statutory references are to the Corporations Code unless otherwise indicated.

corporation. The plaintiff alleges the defendants violated section 25402 and are liable under section 25502.5 to the plaintiff for up to three times the amount the defendants earned by way of their insider trading. The defendants argue that because the issuer was a Delaware corporation and Delaware has no statute analogous to section 25502.5, the internal affairs doctrine as codified in section 2116 prevents the defendants from being held liable under section 25502.5. The trial court agreed and sustained the defendants' demurrers to the plaintiff's insider trading causes of action without leave to amend.

We issued an order to show cause on plaintiff's petition for a writ of mandate. For the reasons we set forth below we grant the petition. Unlike the trial court, we do not believe section 2116's provisions concerning internal corporate governance modify or limit any provision of the Corporate Securities Law of 1968, including in particular section 25502.5. Briefly, while we agree that the duties officers and directors owe a corporation are in the first instance defined by the law of the state of incorporation, such duties are not the subject of California's corporate securities laws in general or section 25502.5 in particular. California's corporate securities laws are designed to protect participants in California's securities marketplace and deter unlawful conduct which takes place here. Because a substantial portion of California's marketplace includes transactions involving securities issued by foreign corporations, the corporate securities laws have been consistently applied to such transactions. There is nothing on the face of section 25502.5 or in its history which suggests that the Legislature intended that it have any narrower scope than other parts of the Corporate Securities Law of 1968.

SUMMARY

Plaintiff and petitioner Robert C. Friese (the trustee) is the Successor Trustee of the Peregrine Litigation Trust, which

itself is successor in interest to and acting in the name and right of the Estate of Peregrine Systems, Inc. The defendants and real parties in interest are former directors and former senior management (defendants)[2] of Peregrine Systems, Inc. (Peregrine), a software manufacturer. Peregrine is a publicly traded Delaware corporation and, as we noted, its headquarters and principal place of business are in San Diego.

According to the allegations of the trustee's complaint, the following circumstances support its claims: In 1997, Peregrine issued its initial public offering (IPO) and its stock was valued at $2.75 per share. Before the IPO, Peregrine's revenue derived mostly from direct sales to end customers. After the IPO, the board of directors implemented a plan to increase revenue by expanding indirect sales to intermediaries who would then resell Peregrine's products to consumers.

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[2] John J. Moores served as a director of Peregrine from March 1989 to March 2003 and as Chairman of the Board from March 1990 through July 2000 and from May 2002 through March 2003. Christopher A. Cole served as President and Chief Executive Officer of Peregrine from 1986 to 1989 and as a director from 1980 to March 2003. Charles E. Noell III served as a director from January 1992 to March 2003. Stephen P. Gardner served as Chief Executive Officer, President and a director from April 1998 to May 2002. Matthew C. Gless served as Vice President, Finance, and Chief Accountant from November 1999 to November 2000 and as Chief Financial Officer and a director from November 2002 to May 2002. Richard T. Nelson served as General Counsel, Corporate Secretary, Vice President of Corporate Development, Senior Vice President of IMG Operations, General Manager of the Xanadu division, Acting Chief Executive Officer and a director during various periods from November 1995 to June 2002. Norris van den Berg served as a director from January 1992 to October 2000. Thomas G. Watrous, served as a director from 1999-2003, appointed to Audit Committee in 2001. Douglas S. Powanda served as a Vice President, Worldwide Sales, and Executive Vice President of Worldwide Operations from January 1998 to July 2001. Frederic B. Luddy served as a Vice President, Research and Development and Chief Technology Officer from July 1997 through August 2003. Trusts controlled by real parties were also named as defendants in the complaint filed in superior court.

In addition to its new sales strategy, Peregrine implemented a new accounting technique. Prior to the IPO, Peregrine employed what is known as the "sell-through" accounting method under which Peregrine recorded revenue when a product was sold to an end user. Following the IPO, Peregrine adopted what is known as the "sell-in" accounting method under which revenue is recorded when a product enters the distribution stream. Peregrine's board of directors adopted the "sell-in" method notwithstanding an admonition from its chief financial officer that this was not a preferred method of recording revenue.

In Peregrine's 1999 public announcements and Securities and Exchange Commission (SEC) filings, Peregrine failed to note that it had adopted the "sell-in" method of recording revenue and that without the new accounting method it would not have met earlier revenue expectations. In fact in 1999 Peregrine posted $138.1 million in revenues, a 123 percent increase over 1998.[3] The increase was largely due to the use of the more aggressive "sell-in" accounting method.

Between April 29, 1999, and August 31, 1999, the defendants collectively sold more than 5.2 million Peregrine shares and received approximately $129 million in proceeds from the stock sales.

In 2000 Peregrine posted revenues of $253.3 million, an increase of 83 percent over the previous year, and the price of its common stock reached an all time high of $79.50 per share. As reported revenues soared, the defendants failed to disclose that indirect sales were exceeding the 25 percent maximum set by Peregrine's auditors, that intermediaries were unable to sell inventory Peregrine had already recorded as revenue, that direct sales were exceedingly low, and that

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[3] Peregrine's fiscal year ends March 31. The 1999 report covered revenues from April 1, 1998, to March 31, 1999.

Peregrine was negotiating a merger defendants knew would likely be negatively received by investors.

Between February 7, 2001, and February 28, 2001, defendants sold over 5 million shares of Peregrine common stock and received in excess of $170 million from the sales. Peregrine posted profits of $564.7 million for 2001, an increase of 123 percent over 2000. Defendants again failed to disclose Peregrine's weak direct sales and reliance on indirect sales.

In May 2002, after Peregrine announced an internal investigation into potential accounting irregularities and the resignation of its chief executive officer, the price of Peregrine's stock dropped 87 percent on April 30, 2002, to 89 cents per share. In September 2002 Peregrine initiated bankruptcy proceedings. During these proceedings, Peregrine cancelled its previously issued common stock, costing shareholders about $4 billion in equity. A restatement of its revenue revealed that Peregrine overstated its profits by more than $500 million, or 38 percent, between April 1999 and December 2001.

On February 24, 2004, the trustee filed a complaint in superior court, alleging violations of California insider trading laws,[4] breach of the fiduciary duty of loyalty, breach of the fiduciary duty of care,[5] waste of corporate assets, conspiracy and unjust enrichment. On April 1, 2005, the trial

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[4] Specifically, the trustee alleged real parties in interest violated section 25402 by selling and transferring Peregrine shares while in possession of material, adverse, nonpublic information. The trustee also alleged Moores and Noell violated section 25403, subdivision (a), by controlling and inducing the sale of company stock in violation of the Corporations Code. (§§ 25402, 25403, subd. (a).)

[5] Alleged against real parties in interest and Richard A. Hosley II, William D. Savoy and Rodney F. Dammeyer. Richard A. Hosley II served as a director from 1992 through 2000. William D. Savoy served as a director from June 2000 to November 2002. Rodney F. Dammeyer served as a director from October 2001 through May 2002.

court sustained the defendants' demurrers to the trustee's insider trading violations without leave to amend. The trial court found that section 2116 and the internal affairs doctrine preclude application of section 25502.5 to the securities the defendants sold. The trustee was given leave to amend his remaining causes of action.

On May 3, 2005, the trustee filed a petition for writ of mandate with this court, challenging the trial court's order sustaining the demurrer. We issued an order to show cause.

DISCUSSION

I

Writ Relief

Writ relief is appropriate here because this case raises an important issue of statutory construction which has not yet been confronted by either this court or our Supreme Court. We also note that, although the trustee was given leave to amend some of his causes of action, it would be wasteful to compel him to fully litigate those claims in the trial court before obtaining a definitive ruling on his insider trading claims. Under these circumstances extraordinary relief is appropriate. (See *Barrett v. Superior Court* (1990) 222 Cal. App.3d 1176, 1183.)

II

Application of California Securities Laws to Foreign Corporations

For the last 100 years California's corporate securities laws have been applied to foreign corporations who do business in this state or whose activities in this state have an impact on this state's securities markets. In *Williams v. Gaylord* (1902) 186 U.S. 157 [22 S.Ct. 798] the Supreme Court was asked to consider application of an 1880 California law which governed mining corporations. The 1880 act provided as follows:

"'Sec. 1. It should not be lawful for the directors of any mining corporation to sell, lease, or otherwise dispose of the whole or any part of the mining ground owned or held by such corporation, nor to purchase or obtain in any way additional mining ground, unless such act be ratified by the holders of at least two thirds of the capital stock of such corporation. Such ratification may be either in writing signed and acknowledged by such stockholders or by resolution duly passed at a stockholders' meeting called for that purpose.'" (*Id.* at p. 158). In *Williams v. Gaylord* a West Virginia mining corporation owned mining ground in California. The plaintiff obtained a mortgage on the corporation's mining ground but did not obtain the necessary shareholder consent. The mortgage secured $50,000 in bonds issued by the corporation. Later, the supplier of materials and labor filed and foreclosed on a mechanics' lien on the same property. The holder of the mechanics' lien argued that the mortgage was unenforceable because the corporation's shareholders had not ratified it. The circuit court and Court of Appeals agreed with the holder of the mechanics' lien. On certiorari the Supreme Court affirmed. The court noted that the California Supreme Court had previously held that the 1880 act applied to foreign corporations. The court then rejected the mortgage holder's contention that the statute improperly intruded upon the internal affairs of a foreign corporation. The court stated: "[W]hen a corporation sells or encumbers its property, incurs debts *or gives securities, it does business, and a statute regulating such transactions does not regulate the internal affairs of the corporation. (Williams v. Gaylord, supra,* 186 U.S. at p. 165, italics added).

The scope of California's securities regulation was considered again in *Western Air Lines, Inc. v. Sobieski* (1961) 191 Cal.App.2d 399 (*Sobieski*). In *Sobieski* the management of a Delaware corporation, which had its headquarters and principal place of business in this state, was engaged in a dispute with minority shareholders. In an effort to frustrate the

minority shareholders' ability to elect directors, the management proposed that the corporation amend its Delaware articles of incorporation to eliminate cumulative voting. The California Commissioner of Corporations determined that any solicitation of proxies approving the elimination of cumulative voting was a sale of securities within the meaning of the Corporations Code and would require a permit from the commissioner. Thereafter, the commissioner denied the corporation's application for a permit. By way of a writ of mandate, the corporation challenged the commissioner's assertion of authority over its attempt to amend its articles. The trial court granted the writ and found, among other matters, that the amendment of the articles of incorporation was an internal affair of the corporation and its shareholders. (*Sobieski, supra*, 191 Cal.App.2d at p. 405.) The Court of Appeal reversed. In rejecting application of the internal affairs doctrine, the court stated: "'"It is true that the courts in California cannot control the internal affairs of any foreign corporation. Such matters are to be conducted in pursuance of and in compliance with the provisions of the charter of the foreign corporation, and the laws of the country where it was created; but in the management and method of its business affairs in California with the citizens and residents thereof, *in the sale or disposition or transfer of the shares of stock*, it must conform to the laws of California in relation to such matters, and is bound thereby. . ."'" (*Sobieski, supra*, 191 Cal.App.2d at pp. 409-410.).

More recently, the scope of California's securities laws was considered in *Diamond Multimedia Systems, Inc. v. Superior Court* (1999) 19 Cal.4th 1036 (*Diamond Multimedia*). In *Diamond Multimedia* the defendants in a nationwide class action lawsuit brought under the unlawful market manipulation provisions of sections 25400 and 25500 argued that California could not provide a remedy for shareholders who did not purchase their shares in California. In rejecting this contention the court found that unlike section 25402,

which is expressly limited to intrastate securities transactions, section 25400 is limited only to unlawful manipulative conduct which occurs in this state. The court found that when such unlawful conduct in California harms out-of-state investors, section 25500 provides them with a remedy even if they did not buy or sell securities in this state. (*Diamond Multimedia, supra,* 19 Cal.4th at p. 1065.) In rejecting the defendants' contention that California had no interest in providing nonresident investors with a remedy, the court stated: "California also has a legitimate and compelling interest in preserving a business climate free of fraud and deceptive practices. California business depends on a national investment market to support our industry. The California remedy for market manipulation helps to ensure that the flow of out-of-state capital necessary to the growth of California business will continue. The Court of Appeal rejected a claim similar to that of petitioners and recognized the importance of extending state-created remedies to out-of-state parties harmed by wrongful conduct occurring in California in *Clothesrigger, Inc. v. G.T.E. Corp.* (1987) 191 Cal.App.3d 605. There the plaintiff sought damages for fraud, negligent misrepresentation and unfair business practices in the charges made by defendant for long distance telephone calls. The trial court denied certification of a nationwide class on the ground that a nationwide class was not suitable as California had no interest in providing greater protection to residents of other states than that provided by their home states. The Court of Appeal reversed that order, noting that defendant had identified no interest of any other state that might be affected by extending California's law to the injured nonresidents, and recognizing that 'California may have an important interest in applying its law to punish and deter the alleged wrongful conduct.' [Citation.]" (*Diamond Multimedia, supra*, 19 Cal.4th at pp. 1064-1065, fn. omitted.)

III

Sections 25402, 25502 and 25502.5

"Insider trading—the use of confidential information not available to the trading public to purchase or sell securities—is prohibited under federal law by section 10(b) of the 1934 Securities Exchange Act and Rule 10b-5 adopted by the Securities Commission pursuant to that statutory provision. Such conduct is also prohibited under provisions of the California Corporate Securities Law of 1968.

"The traditional theoretical justification for prohibiting insider trading is based on the notion that allowing persons who have access to non-public information to use it for securities trading will discourage individual investors without access to such information from trading in the securities markets. Thus, even though persistent arguments have been made by some economists that insider trading is good for the trading markets as a whole and should be permitted, the overwhelming reaction in fact has consistently been to regard it as 'unfair' because it destroys the 'level playing field' among participants in the trading markets.

"In recent years, however, the public objections to insider trading have assumed larger dimensions. While at one time governmental prosecution of small-time insider trading might have been regarded by the general public as overzealous, the discovery of persistent, systematic insider trading activities yielding millions of dollars in profit to well-known securities professionals such as Ivan Boesky and Dennis Levine has changed the underlying objection to insider trading to one of basic morality and cultural values. . . As described by one leading writer, 'Congress has begun to see the problem in more fundamental cultural terms as a manifestation of undue greed among the already well-to-do, worthy of legislative intervention if for no other reason than to send a message of censure on behalf of the American people.'" (Berger, "Issuer

Recovery of Insider Trading Profits Under Section 25502.5 of the California Corporation Code" (1989-1990) 21 Pac. Law Journal 221, 223, fns. omitted (Berger).)

By adoption of sections 25402, 25502 and 25502.5 California has supplemented federal regulation of insider trading. Section 25402 provides as follows: "It is unlawful for an issuer or any person who is an officer, director or controlling person of an issuer or any other person whose relationship to the issuer gives him access, directly or indirectly, to material information about the issuer not generally available to the public, to purchase or sell any security of the issuer in this state at a time when he knows material information about the issuer gained from such relationship which would significantly affect the market price of that security and which is not generally available to the public, and which he knows is not intended to be so available, unless he has reason to believe that the person selling to or buying from him is also in possession of the information."

Section 25402 was enacted in 1968 as part of the Corporate Securities Law of 1968. The face of the statute does not restrict its application to securities issued by domestic corporations. Rather as noted at the outset, by its terms section 25402 is only limited to securities transactions which occur in this state. This literal reading of section 25402 is consistent with the intention of the drafters of the Corporate Securities Law of 1968. In enacting the Corporate Securities Law of 1968, including section 25402, the drafters "agreed that the basis of jurisdiction and regulation should be the offer or sale of securities in this State and *should not be related to the principal place of business or corporate domicile.*" (Marsh & Volk, Practice Under the Cal. Securities Laws, History of Cal. Law § 1.06[3], 1-54, italics added (Marsh & Volk).)

As part of the Corporate Securities Law of 1968, the Legislature provided in section 25502 a civil remedy for violation of section 25402. Section 25502 states: "Any person

who violates Section 25402 shall be liable to the person who purchases a security from him or sells a security to him, for damages equal to the difference between the price at which such security was purchased or sold and the market value which such security would have had at the time of the purchase or sale if the information known to the defendant had been publicly disseminated prior to that time and a reasonable time had elapsed for the market to absorb the information, plus interest at the legal rate, unless the defendant proves that the plaintiff knew the information or that the plaintiff would have purchased or sold at the same price even if the information had been revealed to him."

The remedy provided by section 25502 is problematic because private plaintiffs must establish privity between themselves and violators of section 25402. (See Marsh & Volk, *supra*, Civil Liabilities, § 14.04 [5], 14-55.) Indeed, there is no record of any cases being brought under the provisions of sections 25402 and 25502 between 1968 and 1988. (Berger, *supra*, 21 Pac. Law Journal at p. 233.) However, in the 1980's the integrity of the securities markets was threatened by revelations of extensive insider trading. (Berger, *supra*, 21 Pac. Law Journal at pp. 222-224.) In response to these threats Congress enacted the 1984 Insider Trading Sanctions Act (tit. 15, U.S.C. § 78a, c, o, t, u, ff) and the 1988 Insider Trading & Securities Fraud Enforcement Act (tit. 15, U.S.C. § 78a, b, c, κ, o, t, u, kk). As Professor Berger notes, our Legislature also felt a need to address the issue of insider trading. (Berger, *supra*, 21 Pac. Law Journal at p. 224.) Our Legislature's response to the insider trading scandals of the 1980's was enactment in 1988 of section 25502.5.

Section 25502.5 provides in pertinent part: "(a) Any person other than the issuer who violates Section 25402 shall be liable to the issuer of the security purchased or sold in violation of Section 25402 for damages in an amount up to

three times the difference between the price at which the security was purchased or sold and the market value which the security would have had at the time of the purchase or sale if the information known to the defendant had been publicly disseminated prior to that time and a reasonable time had elapsed for the market to absorb the information and shall be liable to the issuer of the security or to a person who institutes an action under this section in the right of the issuer of the security for reasonable costs and attorney's fees. [¶] . . . [¶]

"(d) This section shall only apply to issuers who have total assets in excess of one million dollars ($1,000,000) and have a class of equity security held of record by 500 or more persons."

Shortly after enactment of section 25502.5 Professor Berger made the following observation: "Except for new section 25502.5 of the California Corporations Code, no other state presently has a statutory provision making a person using inside information liable to the issuer of that security. [¶] . . . . The controversial aspect of such liability is that normally the issuer in whose favor the monetary recovery for insider trading is sought has sustained no monetary damages from the insider's use of confidential information for trading purposes. The enactment in California of section 25502.5 thus seems to be an important legislative decision that the absence of monetary injury to the issuer of the traded security is less important than the *deterrent* of insider trading by superimposing issuer-directed profit disgorgement to the already existing liability towards the person whose securities the insider purchased or towards the person to whom the insider sold." (Berger, *supra*, 21 Pac. Law Journal at p. 226, fn. omitted, italics added.)

IV

Section 2116 and the Internal Affairs Doctrine

Section 2116 states: "The directors of a foreign corporation transacting intrastate business are liable to the corporation, its shareholders, creditors, receiver, liquidator or trustee in bankruptcy for the making of unauthorized dividends, purchase of shares or distribution of assets or false certificates, reports or public notices or other violation of official duty according to any applicable laws of the state or place of incorporation or organization, whether committed or done in this state or elsewhere. Such liability may be enforced in the courts of this state." As applied to directors' liability, section 2116 is a codification of the "internal affairs doctrine." (See *In re Flashcom, Inc.* (2004) 308 B.R. 485, 490.)

"'The internal affairs doctrine is a conflict of laws principle which recognizes that only one State should have the authority to regulate a corporation's internal affairs—matters peculiar to the relationships among or between the corporation and its current officers, directors, and shareholders—because otherwise a corporation could be faced with conflicting demands.' [Citation.] 'States normally look to the State of a business' incorporation for the law that provides the relevant corporate governance general standard of care.' [Citation.]

"'Internal affairs' include 'steps taken in the course of the original incorporation, . . . the adoption of by-laws, the issuance of corporate shares, the holding of directors' and 'shareholders' meetings, . . . *the declaration and payment of dividends* and other distributions, charter amendments, mergers, consolidations, and reorganizations, the reclassification of shares and the purchase and redemption by the corporation of outstanding shares of its own stock.'" [Citations.]

"As stated in the Restatement Second of Conflict of Laws: 'It would be impractical to have matters . . . which involve a

corporation's organic structure or internal administration[] governed by different laws. It would be impractical, for example, if . . . an issuance of shares, *a payment of dividends*, a charter amendment, or a consolidation or reorganization were to be held valid in one state and invalid in another. . . . In the absence of an explicitly applicable local statute to the contrary . . . the local law of the state of incorporation has been applied to determine issues involving corporate acts of the sort [mentioned].' [Citations.]" (*State Farm Mutual Automobile Ins. Co. v. Superior Court* (2003) 114 Cal.App 4th 434, 442-443 (*State Farm*).)

In *State Farm* policyholders in an Illinois mutual insurance company sued the company and alleged that it had failed to properly pay them dividends out of the company's accumulated surplus. The plaintiff policyholders argued that their right to dividends was governed by the substantive law of California. The insurance company argued that under the internal affairs doctrines its dividend obligation was governed by the law of Illinois, where it was incorporated. The court agreed with the insurance company. However, in doing so it took pains to point out that while a corporation's decision to pay dividends was an internal affair, the doctrine had no application to enforcement of a forum state's corporate securities laws. The *State Farm* court, citing *Sobieski*, stated: "This is not to say that, in determining the liability of a foreign corporation, courts must always apply the law of the state of incorporation. In fields like torts, where the typical dispute involves two persons and a single or simple one-shot issue and where the common substantive policy is to spread the loss through compensation and insurance, the preference for forum law and the emphasis on the state interest in forum residents . . . [presents an acceptable application of forum law]. '[Citation.] In the management and method of its business affairs in California with the citizens and residents thereof, in the sale or disposition or transfer of the shares of stock, [a foreign corporation] must conform to the [securities

regulations] of California. . . .' [*Sobieski, supra*, 191 Cal. App.2d at p. 409]." (*State Farm, supra*, 114 Cal.App.4th at p. 447.)

This limitation on the internal affairs doctrine has been adopted by the reporters of Restatement of Conflicts Second. The internal affairs doctrine is set forth in section 309 of the Restatement and provides: "The local law of the state of incorporation will be applied to determine the existence and extent of a director's or officer's liability to the corporation, its creditors and shareholders, except where, with respect to the particular issue, some other state has a more significant relationship under the principles stated in § 6 to the parties and the transaction, in which event the local law of the other state will be applied." In explaining the exception to the general rule, the reporters state: "The rule of this Section will be applied in the absence of an applicable local statute. Many states impose liability by statute upon the directors of foreign corporations for doing, or failing to do, certain acts in the state. *Blue sky laws are typical examples of such statutes.*" (Rest.2d Conflicts of Law, § 309, comment a, italics added.) Professor Witkin has also recognized this limitation on the internal affairs doctrine: "In some situations . . . the local court may, in the interest of justice, take jurisdiction over internal affairs and apply the local law. [Citation.] A typical example is the application of the Corporate Securities [Law of 1968] to protect California residents against fraud in the sale of securities of a foreign corporation." (9 Witkin, Summary of Cal. Law (10th ed.) Corporations, § 239, p. 1006.)

The only reported case which has employed the internal affairs doctrine as codified in section 2116 as a bar to enforcement of California's corporate securities laws is *In re Sagent Technology, Inc. Derivative Litigation* (ND Cal. 2003) 278 F. Supp.2d 1079, 1090 (*Sagent*). In *Sagent* the court dismissed a shareholder's derivative claim brought under section 25402 against corporate directors. It appears from the

court's discussion of the issue that the court was persuaded that the plaintiffs' insider claims were governed by the internal affairs doctrine because of the derivative nature of the claims asserted.[6] The court in *Sagent* did not discuss and apparently did not consider *Williams v. Gaylord*, *Sobieski*, or the other authorities which have consistently found that a state's corporate securities laws are not subject to the internal affairs doctrine. Moreover, the court in *Sagent* did not discuss the history or purpose of California's insider trading prohibitions. For these reasons *Sagent* is not persuasive authority for limitation of those securities laws to securities issued by domestic corporations.[7]

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[6] In distinguishing *Diamond Multimedia* application of California securities laws to out-of-state transactions, the court in *Sagent* stated: "The suit was not a derivative action seeking recovery on behalf of a Delaware corporation, but rather a direct action seeking recovery on behalf of a class of investors for unlawful conduct that had occurred in California. Thus, the reasoning of the California Supreme Court in *Diamond Multimedia* is not directly applicable to the question whether the law of California or the law of Delaware should apply to the insider trading claim. While California, like all states, has an interest in preserving a business climate free of fraud, plaintiffs have not established that California has a more significant relationship to the parties and the transaction than does Delaware. Accordingly, under the provisions of section 309 of the Restatement, the law of Delaware, the state of incorporation, should apply." (*Sagent, supra*, 278 F.Supp. at p. 1091.)

[7] Quite recently, in *Grosset v. Wenaas* (2005) __ Cal.App.4th __ [DAR 12,583 Oct. 20, 2005] (*Grosset*) this court considered the internal affairs doctrine in the context of a derivative lawsuit brought by shareholders who alleged that a Delaware corporation's directors had breached their fiduciary duties to the corporation by, among other matters, allowing the corporation to be sued for insider trading. In addition the plaintiffs alleged that the directors had themselves engaged in insider trading. In response to the derivative action, the corporation appointed a special litigation committee of disinterested board members. The committee retained counsel who investigated the derivative claim. In large part because analogous federal insider trading claims had been dismissed, the committee and the counsel it retained concluded that pursuit of the derivative lawsuit was

V

The Trustee's Section 25502.5 Claims are Not Barred by the Internal Affairs Doctrine

Contrary to the defendants' contention, the internal affairs doctrine as embodied in section 2116 does not prevent the trustee from bringing claims against them under section 25502.5. The defendants appear to accept the proposition that the Legislature's historic and well-established intent to regulate both intrastate conduct and intrastate securities transactions subject securities transactions which take place in this state to California's securities laws even if those securities are issued by foreign corporations. (See *Williams v. Gaylord*, *supra*, 186 U.S. at p. 165; *Sobieski*, *supra*, 191 Cal.App.2d at pp. 409-410; *Diamond Multimedia, supra*, 19 Cal.4th at pp. 1064-1065; Marsh & Volk, *supra*, § 1.06[3],

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not in the corporation's best interest. Accordingly, the committee moved to dismiss the derivative action. The trial court granted the committee's motion.

While the plaintiffs' appeal of the order dismissing the derivative action was pending, the defendant directors moved to dismiss the appeal on the grounds that, by virtue of a merger in which the plaintiffs' shares were repurchased by the corporation, the plaintiffs no longer owned shares in the corporation and under Delaware law no longer had standing to assert a derivative claim against the corporation. In granting the motion we found that the internal affairs doctrine governed the plaintiffs' standing to bring a derivative action. Relying on *State Farm*, we stated: "The issue of whether a stockholder has standing to pursue a derivative action based upon stock ownership is an issue that concerns the relationship between a corporation and its shareholders because it is asking whether a stockholder will be allowed to maintain an action on behalf of the corporation. One definition of an internal affair is the extent of a shareholder's right ""to participate in the administration of the affairs of the corporation . . . .""" (*State Farm, supra*, 114 Cal.App.4th at p. 443.)" (*Grosset v. Wenass*, *supra*, __ Cal.App.4th __ [slip. opn., p. 16].) Our discussion of standing in a derivative lawsuit did not reach the question we are asked to consider here, to wit: is section 25502.5 subject to the internal affairs doctrine as codified in section 2116.

1-54; Rest.2d Conflicts of Law, § 309, comment a; 9 Witkin, Summary of Cal. Law (10th ed.) Corporations, § 239, p. 1006.) The defendants argue however that an issuer's claim under section 25502.5 is *not* a securities regulation. Rather they suggest section 25502.5 gives rise to no more than a derivative breach of fiduciary duty claim which they argue is, for that reason, subject to the internal affairs doctrine. For a number of reasons we do not accept the defendants' characterization of section 25502.5 as merely a device for enforcing directors' and officers' fiduciary duties to shareholders.

The defendants' characterization of section 25502.5 ignores the fact that, like section 25402, it is part of the Corporate Securities Law of 1968. The defendants also ignore the fact that section 25502.5 is a remedy for the substantive insider trading prohibition set forth in section 25402. As we have noted the prohibition on insider trading was adopted as a means of protecting investor confidence in the securities market and more broadly as a means of punishing what is perceived by the public as immoral conduct. (See Berger, *supra*, 21 Pac. Law. Journal, at pp. 222-224, 226.) These public interests are much broader than protection of a corporation's shareholders.

The defendants' assertion that section 25502.5 is limited to protection of shareholder interests also ignores two important aspects of insider trading regulation.

First, as Professor Berger has noted, in general corporations are not damaged when either they or their directors engage in insider trading. (Berger, *supra*, 21 Pac. Law Journal at p. 226.) Thus section 25502.5 cannot be characterized as a means of compensating a corporation for losses it actually experiences when an officer or director engages in insider trading. Secondly, section 25402 prohibits issuers themselves from engaging in insider trading. Thus in compelling an officer or director to disgorge to an issuer profits realized by way of insider trading, section 25502.5 does not provide the issuer

with compensation for any lost opportunity the issuer itself could have lawfully realized. These circumstances undermine the defendants' contention that section 25502.5 is a remedy for any breach of fiduciary duty owed to the corporation. Section 25502.5 does not compensate for any loss a corporation experiences or recover any lawful corporate opportunity.

Reinforcing the public interest served by section 25502.5, as opposed to any narrow shareholder interest, are the treble profits the statute permits an issuer to collect from a violator of section 25402. The deterrence provided by this provision clearly demonstrates that in enacting section 25502.5 the Legislature was very much concerned about discouraging conduct it found destructive to the public interest.

In sum, the history of section 25502.5 and its provisions make it clear that it is very much a part of California's corporate securities regulation scheme and serves broad public interests rather than the more narrow interests of a corporation's shareholders. Given the public and regulatory interests section 25502.5 serves, it is not subject to the internal affairs doctrine as codified in section 2116.

Let a writ of mandate issue directing the trial court to vacate its order sustaining the defendants' demurrers to the trustee's insider trading claims and enter an order overruling the demurrers to the insider trading claims. Costs in the writ proceeding are awarded to the trustee.

CERTIFIED FOR PUBLICATION

/s/ Benke
BENKE, Acting P. J.

WE CONCUR:

/s/ McDonald
McDONALD, J.

/s/ McIntyre
McINTYRE, J.

APPENDIX F

SUPERIOR COURT OF CALIFORNIA,
COUNTY OF SAN DIEGO

Number: GIC788659	**Complaint Date:** 05-15-02	**Hearing Date:** 04/01/05	**Hearing Time:** 08:30AM	**Dept.** 65
Judge/Commissioner: Hon. Joan M. Lewis		**Clerk:** Regina Lindsey-Cooper		
Reporter: Jacqueline Plummer P.O. Box 120128 San Diego, CA 92112-0128		**CSR # :** 7688		
Plaintiff/Petitioner: Peregrine Litigation Trust		**Defendant/Respondent:** Stephen P. Gardner, et al.		
Attorney for Plaintiff/Petitioner: Marisa Janine-Page ☒ P ☐ NP		**Attorney for Defendant/Respondent:** Alison P. Adema (2) ☐ P ☐ NP Christopher H. McGrath (4) ☒ P ☐ NP John S. Quinn (1) ☒ P ☐ NP Kathryn D. Horning (3) ☒ P ☐ NP Robert S. Brewer (5) ☒ P ☐ NP		

* See CMC for all appearances.

1. DEFENDANT DEMURRER
2. DEFENDANT DEMURRER
3. DEFENDANT DEMURRER
4. DEFENDANT DEMURRER
5. DEFENDANT DEMURRER
1. DEFENDANT MTN TO STRIKE
2. DEFENDANT MTN TO STRIKE
3. DEFENDANT JOINDER BY T.G. WATROUS (JOINS IN MOORES DEMURRER)
4. DEFENDANT JOINDER BY S.P. GARDNER (JOINS IN MOORES DEMURRER)
5. DEFENDANT JOINDER BY R. DAMMEYER (JOINS MOORES, SAVOY, NOELL'S DEMURRER)
1. DEFENDANT JOINDER BY C.A. COLE (JOINS IN MOORES DEMURRER)

THIS MATTER HAVING COME BEFORE THE COURT THIS DATE, THE COURT ORDERS:

☐ Prior To Calendar Call	☐ Off-Calendar	☐ Granted ☐ Denied	☐ Bonds ☐ With/ Without Prejudice
☐ Prior To Calendar Call	☐ Cont. To__ In Dept.__ At__		
☐ TRO	☐ Continued	☐ Vacated	
☐ All Previous Orders Remain In Full Force And Effect			
☐ Oral Argument	Tentative Dated: 4-1-05	☒ Confirmed	☒ Modified
☐ Disposes Of Entire Action		☐ Does Not Dispose Of Entire Action	
☐ Prevailing Party To Prepare And File Formal Order Pursuant To CRC 391			
☐ Other			

Preliminarily, the Court notes that throughout the parties' papers counsel referenced, incorporated and joined arguments contained in other filings. This was not helpful to the Court and appears, in certain circumstances, to have been an attempt to circumvent the Court's ruling relative to page limitations. In the future, absent order of Court, this type of incorporation by reference will not be considered.

The following Defendants have filed demurrers to the Amended Consolidated Complaint ("the Complaint") in this action. John J. Moores, individually and as trustee, and JMI Services, Inc.; Charles E. Noell, III, Norris van den Berg and Richard A. Hosley, II; William D. Savoy; Frederic B. Luddy; and Richard Nelson. Joinders have been filed by Defendants Thomas G. Watrous; Stephen P. Gardner; Rod Dammeyer; and Christopher Colde. The Court's ruling relative to the demurrers applies to any party that joined in the demurrers.

After having reviewed and considered all papers submitted, the Court rules as follows.

The demurrers to the first through fifth causes of action are sustained on the basis that Delaware law governs the relationship between Peregrine and its directors and/or officers. It is undisputed that Peregrine was incorporated in the State of Delaware. The Court finds that Calif. Corp. Code Sec. 2116 and the internal affairs doctrine require application of Delaware law. Plaintiff argued that California law should control, relying principally on *Diamond Multimedia Sys. Inc. v. Superior Court* (1999) 19 Cal. 4th 1036. *Diamond Multimedia*, however, concerned different statutes and a different issue than is before this Court and is therefore distinguishable. *See In re Sagent Tech., Inc. Deriv. Litig.*, 278 F. Supp.2d 1079 (N.D. Cal. 2003). Because the first five causes of action of the complaint are for violations of statutes this Court finds to be not applicable, the demurrers to the first through fifth causes of action are sustained without leave to amend.

The demurrers to the sixth cause of action are sustained with 30 days leave to amend for Plaintiff to plead, if possible, facts to satisfy the element of scienter.

Additionally, the Court believes that Plaintiff must be able to plead some damage for this cause of action to proceed. To the extent Plaintiff's damage claim is limited to its "damaged reputation, diminished goodwill, litigation costs, and bankruptcy expenses" as pled at Para. 14 of the Complaint, Plaintiff must plead a casual connection between the demurring Defendants' conduct and this alleged harm.

The director demurrers to the seventh cause of action are sustained. In sustaining the demurrer, the Court finds these claims, as currently pled, are barred by Peregrine's Certificate of Incorporation which eliminated liability for breaches of the duty of care and/or by the business judgment rule. To the extent facts could be pled which would demonstrate an exception to the benefits of the certificate or the business judgment rule, Plaintiff is given 30 days leave to amend to plead such facts.

The demurrers of Defendant Luddy and Nelson to the sixth and seventh causes of action are further sustained with 14 days leave to amend for Plaintiff to plead the factual basis for its claim that these officers owed fiduciary duties under the facts alleged in this case.

The demurrers to the eighth cause of action for corporate waste are sustained with 30 days leave to amend for Plaintiff to plead, if possible, the diversion of corporate assets.

The demurrers to the ninth cause of action for conspiracy are sustained with 30 days leave to amend. In light of the fact that the Court finds the complaint, as currently pled, fails to state any actionable conduct against the demurring Defendants, the conspiracy cause of action would fail.

The demurrers to the tenth causes of action are sustained with 30 days leave to amend for Plaintiff to plead, if possible, that it was harmed as a result of any conduct on the part of these Defendants.

The motions to strike are off calendar as moot in light of the rulings on the demurrers. However, the Court notes that if Plaintiff amends its complaint any basis for tolling a limitations period shall be pled.

In ruling on the demurrers and motions to strike the Court took judicial notice where appropriate under the Evidence Code. Any concerns regarding the scope of judicial notice may be addressed at the time of the hearing.

IT IS SO ORDERED

Dated: 4/1/2005

/s/ Joan M. Lewis
HON. JOAN M. LEWIS
Judge of the Superior Court

APPENDIX G

CALIFORNIA CORPORATIONS CODE

Section 2116

§ 2116. The directors of a foreign corporation transacting intrastate business are liable to the corporation, its shareholders, creditors, receiver, liquidator or trustee in bankruptcy for the making of unauthorized dividends, purchase of shares or distribution of assets or false certificates, reports or public notices or other violation of official duty according to any applicable laws of the state or place of incorporation or organization, whether committed or done in this state or elsewhere. Such liability may be enforced in the courts of this state.

* * * *

Section 25402

§ 25402. It is unlawful for an issuer or any person who is an officer, director or controlling person of an issuer or any other person whose relationship to the issuer gives him access, directly or indirectly, to material information about the issuer not generally available to the public, to purchase or sell any security of the issuer in this state at a time when he knows material information about the issuer gained from such relationship which would significantly affect the market price of that security and which is not generally available to the public, and which he knows is not intended to be so available, unless he has reason to believe that the person selling to or buying from him is also in possession of the information.

* * * *

Section 25502.5

§ 25502.5. (a) Any person other than the issuer who violates Section 25402 shall be liable to the issuer of the security purchased or sold in violation of Section 25402 for damages

in an amount up to three times the difference between the price at which the security was purchased or sold and the market value which the security would have had at the time of the purchase or sale if the information known to the defendant had been publicly disseminated prior to that time and a reasonable time had elapsed for the market to absorb the information and shall be liable to the issuer of the security or to a person who institutes an action under this section in the right of the issuer of the security for reasonable costs and attorney's fees.

(b) The amounts recoverable under this section by the issuer shall be reduced by any amount paid by the defendant in a proceeding brought by the Securities and Exchange Commission with respect to the same transaction or transactions under the federal Insider Trading Sanctions Act of 1984 (15 U.S.C. Secs. 78a, 78c, 78o, 78t, 78u, and 78ff) or any other act regardless of whether the amount was paid pursuant to a judgment or settlement or paid before or after the filing of an action by the plaintiff against the defendant. If a proceeding has been commenced by the Securities and Exchange Commission but has not been finally resolved, the court shall delay entering a judgment for the plaintiff under this section until that proceeding is resolved.

(c) If any shareholder of an issuer alleges to the board that there has been a violation of this section, the board shall be required to consider the allegation in good faith, and if the allegation involves misconduct by any director, that director shall not be entitled to vote on any matter involving the allegation. However, that director may be counted in determining the presence of a quorum at a meeting of the board or a committee of the board.

(d) This section shall only apply to issuers who have total assets in excess of one million dollars ($1,000,000) and have a class of equity security held of record by 500 or more persons.

APPENDIX H

SUPERIOR COURT FOR THE STATE OF CALIFORNIA
COUNTY OF SAN DIEGO

Consolidated Case No.: GIC 788659

PEREGRINE LITIGATION TRUST,
Plaintiff,

v.

JOHN J. MOORES, *et al.*,
Defendants.

Date:	April 1, 2005
Time:	8:30 a.m.
Courtroom:	Department 65
Judge:	Hon. Joan M. Lewis

CORRECTED AMENDED NOTICE OF DEMURRERS AND DEMURRERS OF DEFENDANT JOHN J. MOORES, INDIVIDUALLY AND AS TRUSTEE, AND JMI SERVICES, INC. TO AMENDED CONSOLIDATED COMPLAINT; MEMORANDUM OF POINTS AND AUTHORITIES IN SUPPORT THEREOF

[Revised per Court's January 14, 2005 instructions]

[Filed Concurrently Herewith:
(1) Declaration of Sarah J. Cole;
(2) Request for Judicial Notice; and
(3) Notice of Lodging of Non-California Authorities]

* * * *

[FN2] Mr. Moores and JMI Services reserve all other objections to purported claims under Cal. Corp. Code § 25502.5, even if not asserted herein. These include preemption, unconsti-

tutionality of the statute and its duplicative recoveries under the Due Process Clause and the Commerce Clause, and the prohibition on assignment of punitive claims. *See State Farm Mut. Auto. Ins. Co. v. Campbell*, 538 U.S. 408, 416-18 (2003) (limiting punitive awards); *CTS Corp. v. Dynamics Corp. of Am.*, 481 U.S. 69 (1987); *McDermott Inc. v. Lewis*, 531 A.2d 206, 217 n.12 (Del. 1987) (*CTS Corp.* makes clear "that the commerce clause mandates that a state apply the internal affairs doctrine"). *See generally* Don Berger, *Issuer Recovery of Insider Trading Profits Under Section 25502.5 of the California Corporations Code*, 21 Pac. L.J. 221, 224 (1990) (raising questions regarding the duplicative recoveries purportedly permitted by § 25502.5); Demurrer of Richard T. Nelson (raising assignment defects).

* * * *

DATED: March 22, 2005

QUINN EMANUEL URQUHART OLIVER & HEDGES, LLP

By /s/ Harry A. Olivar, Jr.
Harry A. Olivar, Jr.
Attorneys for Defendants John J. Moores, Individually and as Trustee, and JMI Services, Inc.

APPENDIX I

IN THE COURT OF APPEAL
OF THE STATE OF CALIFORNIA
FOURTH APPELLATE DISTRICT, DIVISION ONE

Civil Number D046348

PEREGRINE LITIGATION TRUST,
in the name of Peregrine Systems, Inc.,
Petitioner,

v.

SUPERIOR COURT OF CALIFORNIA
FOR THE COUNTY OF SAN DIEGO,
Respondent.

San Diego Superior Court Case No. GIC 788659
April 1, 2005 Order of the Hon. Joan M. Lewis

Return to Order to Show Cause of Real Parties in Interest
John J. Moores, Charles E. Noell, III, Norris van den Berg,
Christopher A. Cole, Thomas G. Watrous, and
JMI Services, Inc.

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* * * *

III. APPLYING SECTION 25502.5 TO A FOREIGN CORPORATION'S CLAIMS AGAINST ITS OWN DIRECTORS AND OFFICERS WOULD VIOLATE THE COMMERCE AND DUE PROCESS CLAUSES OF THE UNITED STATES CONSTITUTION.

The principle of "constitutional avoidance" is well established: a statute should be read in a way that causes it to pass constitutional muster. *See Dyna-Med, Inc. v. Fair Employment & Housing Comm'n*, 43 Cal. 3d 1379, 1387 (1987) ("A statute should be construed whenever possible so as to preserve its constitutionality."). Petitioner's reading of Section 25502.5 does the opposite.

A. An Attempt by California to Regulate Claims by a Foreign Corporation Against Its Own Directors and Officers for Unlawful Trading on a National Market Would Violate the Commerce Clause.

To determine whether a law violates the Commerce Clause, a court determines whether the law directly or indirectly regulates interstate commerce. *See* Deborah A. DeMott, *Perspectives on Choice of Law for Corporate Internal Affairs*, 48 Law & Contemp. Probs. 161, 185 (1985) (hereinafter "DeMott, *Perspectives*"). A direct regulation of interstate commerce is always prohibited. *Edgar v. MITE Corp.*, 457 U.S. 624, 640 (1982). An indirect regulation is prohibited if the burden on interstate commerce is disproportionate to any legitimate local interests furthered by the regulation. *Id.*; DeMott, *Perspectives*, at 185. The United States Supreme Court has held that the burden on interstate commerce is disproportionate when the regulation "subject[s] activities to inconsistent regulations." *CTS Corp. v. Dynamics Corp.*, 481 U.S. 69, 88 (1987).

1. *Section 25502.5, as Interpreted by Petitioner, Would Be an Impermissible Direct Regulation of Interstate Commerce.*

Under Petitioner's interpretation of Section 25502.5, California would supply the rule of decision for claims by a foreign corporation against its directors or officers whenever an offer to sell "originates" from California. *See* Petition at 16. That would mean that California law would apply if a director were to make a telephone call while physically present in California to her broker in another state to direct a sale on a national market. California law would also apply if the director were to sign onto the internet while physically present in California to direct a sale on a national market from an online brokerage account. This interpretation of Section 25502.5 would violate the Commerce Clause because it would result in California's direct regulation of interstate commerce.

The United States Supreme Court considered a similar situation in *Edgar*. There, Illinois sought to regulate takeover offers directed at certain target companies operating in Illinois. *Edgar*, 457 U.S. at 626-27. The Supreme Court plurality held that the law directly regulated interstate commerce in violation of the Commerce Clause:

> A tender offer for securities of a publicly held corporation is ordinarily communicated by the use of the mails or other means of interstate commerce to shareholders across the country and abroad. . . . [Defendant] . . . necessarily employed interstate facilities in communicating its offer, which, if accepted, would result in transactions occurring across state lines. These transactions would themselves be interstate commerce. . . . *Indeed, the Illinois law on its face would apply even if not a single [shareholder] were a resident of Illinois* . . . . It is therefore apparent that the Illinois statute is a direct restraint on interstate commerce . . . .

Id. at 641-42 (emphasis added).

For the same reasons that the Illinois statute was a direct regulation of interstate commerce, Section 25502.5, as interpreted by Petitioner, would be also. Under Petitioner's reading, the statute would apply to offers communicated by the use of the telephone, internet, or other means of interstate commerce—and to purchases and sales transactions taking place across state lines. The statute would apply even if the corporation were a foreign corporation with no directors or shareholders who were California residents. A director of a foreign corporation with no California shareholders could be sued by her own corporation under California law merely because she set foot in California and directed a purchase or sale on a national exchange. Not surprisingly, the Commerce Clause prohibits this result. *See id.* at 640.

2. *Section 25502.5, as Interpreted by Petitioner, Is an Impermissible Indirect Regulation of Interstate Commerce.*

As the United States Supreme Court has recognized, a statute that regulates the internal affairs of a corporation is an impermissible indirect regulation of interstate commerce because it does not promote any legitimate local interests: "[A] state 'has no interest in regulating the internal affairs of foreign corporations.'" *VantagePoint Venture Partners 1996 v. Examen, Inc.*, 871 A.2d 1108, 1113 (Del. 2005) (quoting *Edgar*, 457 U.S. at 645-46); *see also CTS Corp.*, 481 U.S. at 93 ("[A state] has no interest in protecting nonresident shareholders *of nonresident corporations*.") (emphasis in original). "[A]pplication of local internal affairs law . . . to a foreign corporation . . . is 'apt to produce inequalities, intolerable confusion, and uncertainty, and intrude into the domain of other states that have a superior claim to regulate the same subject matter.'" *VantagePoint*, 871 A.2d at 1114.

If applied to regulate claims by a foreign corporation against its directors and officers, which involve the internal affairs of the corporation, *see supra* Section I.B, Section

25502.5 would not promote any legitimate local interest. And it would disproportionately burden interstate commerce. An indirect regulation of interstate commerce is disproportionately burdensome when it subjects an activity to inconsistent regulations. *CTS Corp.*, 481 U.S. at 88. As interpreted by Petitioner, Section 25502.5 would subject foreign corporations and their directors and officers to inconsistent regulations in two ways.

First, under Petitioner's interpretation of Section 25502.5, directors and officers could be liable to Peregrine under California law for treble their trading profits merely by trading at a time when they possessed material, non-public information, *i.e.*, *scienter* would not be required. *See* Petition at 8 (arguing that Section 25502.5 allows recovery of treble a director's profits any time the director trades while possessing material, non-public information). This is contrary to Delaware law. *See Guttman v. Huang*, 823 A.2d 492, 505 (Del. Ch. 2003) (holding that Delaware law allows recovery of a director's profits only if he trades because of material, non-public information).

Second, Petitioner's interpretation would require Peregrine to declare any director accused of violating Section 25402 "interested," and hence disqualified from voting on whether the corporation should pursue legal action. *See* Cal. Corp. Code § 25502.5(c) (a director is "interested" and must abstain from voting if he is accused of unlawful trading). This is also contrary to Delaware law. *See Guttman*, 823 A.2d at 502 ("As a matter of course, corporate insiders sell company stock. . . . [I]t is unwise to formulate a common law rule that makes a director 'interested' whenever a derivative plaintiff cursorily alleges that he made sales of company stock in the market at a time when he possessed material, non-public information.").

Petitioner's expansive interpretation of Section 25502.5 would thus subject the internal activities of Peregrine to in-

consistent regulations in violation of the Commerce Clause. It cannot be the law. *See CTS Corp.*, 481 U.S. at 88; *Dyna-Med*, 43 Cal. 3d at 1387.

B. Allowing a Delaware Corporation to Sue Its Directors for Trading Under California Law Would Violate the Due Process Clause.

In inducing Real Parties to serve as directors, Peregrine represented to them that any liability they might have to the corporation would be governed by Delaware law. *See* Ex. 7-E at 285-94. This commitment that claims against the directors would be governed by Delaware law was confirmed by the company in its Certificate of Incorporation, wherein Peregrine expressly invoked and relied upon Delaware law to define the scope of its directors' liability to the corporation:

> The Company has adopted provisions in its Amended and Restated Certificate of Incorporation that eliminate to the fullest extent permissible under Delaware law the liability of its directors to the Company for monetary damages.

Ex. 7-D at 274; Ex. 7-N at 443. Further, the Confirmation Order of the Delaware Bankruptcy Court recognized that any liability the directors may have to Peregrine or the Litigation Trust, its assignee, is to be determined under Delaware law. *See* Ex. 7-F at 314-15, ¶56.

Real Parties and all other persons who accepted invitations to become directors were entitled to rely on the representation that Delaware law would govern their rights and duties with respect to Peregrine. *See Fasciana v. Electronic Data Sys. Corp.*, 829 A.2d 160, 170 (Del. Ch. 2003) ("Without affording . . . protection [on which directors can rely], corporations would find it difficult to retain high-quality directors . . ., especially ones willing to make socially useful decisions that involve economic risk."). Petitioner's effort to renege on Peregrine's prior representations and commitments to its

directors and invoke another state's law that subjects them to punitive damages, if accomplished, would be fundamentally unfair and violate the directors' due process rights under the United States Constitution for two reasons.

First, any decision that frustrates the directors' expectations, created by Peregrine, that any liability to Peregrine would be governed by Delaware law would violate the Due Process Clause. *See Norwest Mortgage, Inc. v. Superior Court*, 72 Cal. App. 4th 214, 227 n.16 (1999) ("Our conclusion that application of California law would offend due process limitations is further supported by [the] observation that '[w]hen considering fairness in this context, an important element is the expectation of the parties. . . . Here, there is no basis to conclude any non-Californian expected California law would govern his claim; instead, the contractual relationship between [defendant] and the borrowers specified the law of place of the encumbered property would govern."). Like the parties in *Norwest Mortgage*, Real Parties here never expected that California law (or the law of any state other than Delaware) would govern claims Peregrine might assert against them for violations of duty. These expectations were reasonable because, for among other reasons, Peregrine repeatedly represented to its directors that Delaware law would apply. *See* Ex. 7-D at 274; Ex. 7-E at 285-294. The only reason that California law is now being invoked is because Petitioner wants to take advantage of the perceived friendliness of California's punitive treble damages provision. Due process considerations prevent it from doing so after the fact. *Norwest Mortgage*, 72 Cal. App. 4th at 227 n.16.

Second, the internal affairs doctrine requires that one state's laws—those of the state of incorporation—govern Peregrine's claims against its directors and officers. *See supra* Section I.B. This is because "[w]ith the existence of multistate and multinational organizations, directors and officers have a significant right . . . to know what law will be

applied to their actions." *State Farm*, 114 Cal. App. 4th at 444. This right is also a constitutional right protected by the Due Process Clause. *See VantagePoint Venture Partners 1996 v. Examen, Inc.*, 871 A.2d 1108, 1113 (Del. 2005).

If it were constitutionally permissible for another state to apply its local law to a Delaware corporation's claims against its own directors, directors would never know what law would apply to their actions. Well-traveled directors could conceivably be liable to their own corporations under 50 different legal standards imposed by 50 different states, depending upon a factual determination as to where a director's purchase or sale "originated." *See* Petition at 16. "To require a factual determination to decide which of two conflicting state laws governs the internal affairs of a corporation at any point in time, completely contravenes the importance of stability within inter-corporate relationships that the United States Supreme Court recognized" and would violate the directors' due process rights. *VantagePoint*, 871 A.2d at 1113-15. Moreover, directors could simultaneously be liable under the laws of more than one state for the same transaction. For example, one state might contend its law governs sales originating in the state; another might contend its law governs sales executed in the state. The same sale could originate in one state and be executed in another. Petitioner's view of Section 25502.5 cannot be the law. *See Dyna-Med*, 43 Cal. 3d at 1387.

* * * *

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APPENDIX J

IN THE COURT OF APPEAL
OF THE STATE OF CALIFORNIA
FOURTH APPELLATE DISTRICT, DIVISION ONE

Civil Number D046348

PEREGRINE LITIGATION TRUST,
in the name of Peregrine Systems, Inc.,
Petitioner,

v.

SUPERIOR COURT OF CALIFORNIA
FOR THE COUNTY OF SAN DIEGO,
Respondent.

San Diego Superior Court Case No. GIC 788659
April 1, 2005 Order of the Hon. Joan M. Lewis

Petition for Rehearing of Real Parties in Interest
John J. Moores, Charles E. Noell, III, Norris van den Berg,
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* * * *

B. *The Court's Opinion Does Not Address Real Parties' Commerce Clause and Due Process Clause Arguments.*

It is clear that the Court must interpret a statute in "light of the constitutional restrictions upon the power of the legislature." *County of Los Angeles v. Riley* (1936) 6 Cal. 2d 625, 628-29. Where, for example, the subject statute is unconstitutionally overbroad because the enactment is silent as to the scope of its application, it will be presumed that the Legislature intended to limit the statute's reach so as to make it valid and constitutional. *People v. Globe Grain & Mill. Co.* (1930) 211 Cal. 121, 127. Any interpretation of a statute should dispose of constitutional attack by reading necessary limitations *into* the statute. *See People v. Globe Grain & Mill Co.* (1930) 211 Cal. 121, 127.

In their opposition to the instant writ, Real Parties pointed out that (1) any attempt by California to regulate claims by an out-of-state corporation against its own directors and officers for alleged unlawful trading on a national market would violate the Commerce Clause of the United States Constitution; and (2) any statute that would purport to allow Peregrine, a Delaware corporation that repeatedly represented that its relationship with its directors would be governed by Delaware law, to change position and sue its own directors under California law would violate the Due Process Clause of the United States Constitution. *See* Return at 28-37.

Unfortunately, the Court's opinion is bereft of any discussion of these constitutional issues as they relate to the interpretation of Section 25502.5. There is no indication that the Court construed the statute "in a manner that is consistent with applicable constitutional provisions, seeking to harmonize the Constitution and the statute." *California Housing Finance Agency v. Elliott* (1976) 17 Cal. 3d 575, 594.

Instead, the Court's opinion highlights the constitutional concerns raised by Real Parties in their briefing and at oral argument. Contrary to Petitioner's recent statement to the media—that "California law as it now reads properly would control these transactions, not only the insider trading transactions but the breach of duty allegations," *see* "Peregrine Ruling Is Reversed on Appeal," San Diego Union Tribune, Dec. 6, 2005, available at http://www.signonsandiego.com/uniontrib/20051206/news_1b6peregrine.html—the Court's opinion indicates the opposite is true. The opinion as written now distinguishes between "insider trading" claims assertedly governed by California law and "breach of the fiduciary duty of loyalty" claims assertedly governed by Delaware law. *See* Opinion at 5, 8. Under the opinion as written, Petitioner can now pursue claims against Real Parties under multiple states' laws, even though the claims arise from exactly the same set of facts. Because the Court's opinion allows Petitioner to pursue claims under different states' laws based on the same set of facts, it subjects Real Parties' activities to inconsistent regulation in violation of the Commerce Clause and violates Real Parties' Due Process right to know what standards will govern their actions. *See* Return at 32-33, 36.[2]

There is no readily apparent reason for the Court to sidestep the constitutional issues. If the Court has considered and rejected Real Parties' constitutional arguments, then the Court's analysis should be included in the opinion. *People v. Rojas* (1981) 118 Cal. App. 3d 278, 288-89 (constitutional

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[2] If Petitioner is correct in proclaiming to the media that the Court has now replaced Delaware law with California law as the rule of decision for breach of fiduciary duty claims, the opinion runs even further afoul of the Commerce Clause. The opinion would then "intrude into the domain of other states that have a superior claim to regulate the same subject matter" in violation of the U.S. Constitution. *See VantagePoint Venture Partners 1996 v. Examen, Inc.*, 871 A.2d 1108, 1114 (Del. 2005).

requirement (Cal. Const., Art. IV, §14) of a written decision "with reasons stated" is "designed to insure that the reviewing court gives careful thought and consideration to the case and that the statement of reasons indicate that [parties'] contentions have been reviewed and consciously, as distinguished from inadvertently, rejected"). If, on the other hand, the Court has overlooked the issues, then rehearing would clearly be warranted. *San Francisco v. Pacific Bank*, 89 Cal. at 25.

* * * *

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APPENDIX K

IN THE SUPREME COURT
OF THE STATE OF CALIFORNIA

Supreme Court No. __
4th Civil No. D046348

ROBERT C. FRIESE, as Trustee,
Petitioner,

v.

THE SUPERIOR COURT OF SAN DIEGO COUNTY,
Respondent,

JOHN J. MOORES *et al.*,
Real Parties in Interest.

San Diego Superior Court Case No. GIC 788659
April 1, 2005 Order of the Hon. Joan M. Lewis

Petition for Review of Real Parties in Interest
John J. Moores, Charles E. Noell, III, Norris van den Berg,
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* * * *

IV.

REVIEW SHOULD BE GRANTED TO AVOID THE SERIOUS FEDERAL CONSTITUTIONAL QUESTIONS RAISED BY THE COURT OF APPEAL'S EXTENSION OF CALIFORNIA LAW TO THE INTERNAL AFFAIRS OF A DELAWARE CORPORATION.

The Court of Appeal's application of Section 25502.5 to a foreign corporation's fiduciary duty claims against its own directors and officers raises serious questions under the federal Commerce Clause and Due Process Clause. As explained above in Part I, these serious questions may be avoided by a statutory construction that holds such claims to be matters of internal affairs governed by the law of the state of incorporation. The need to avoid possible federal constitutional violations presents an additional reason why this case raises such important legal questions warranting this Court's review. *See Dyna-Med, Inc. v. Fair Employment & Housing Comm'n* (1987) 43 Cal. 3d 1379, 1387 ("A statute should be construed whenever possible so as to preserve its constitutionality.").

First, the Court of Appeal's decision allows Section 25502.5(a) to govern claims by an out-of-state corporation against its own directors and officers, who may not be California residents, for trading shares on a national exchange as long as the offer to trade "originated" from California. *See Opinion* at A5, A14-A15; Cal. Corp. Code § 25008 (defining purchase or sale of a security). Such regulation of purchase and sale transactions across state lines raises a serious issue of possible direct burden on interstate commerce in violation of the Commerce Clause. *See Edgar v. MITE Corp.*, 457 U.S. 624, 640 (1982) (holding that an Illinois law regulating tender

offers of target companies operating in Illinois violated the Commerce Clause because the tender offer is communicated through means of interstate commerce and the takeover is an interstate transaction). Serious Commerce Clause questions are likewise raised by the Court of Appeal's decision that a California statute regulating board quorum and voting requirements and other internal affairs may be applied extraterritorially to foreign corporations. *See supra* Section III.B; *VantagePoint*, 871 A.2d at 1113 ("[A] state 'has no interest in regulating the internal affairs of foreign corporations.'") (quoting *Edgar*, 457 U.S. at 645-46); *see also CTS Corp. v. Dynamics Corp.*, 481 U.S. 69, 93 (1987) ("[A state] has no interest in protecting nonresident shareholders *of nonresident corporations*.") (emphasis in original).

Second, application of Section 25502.5 to foreign corporations raises serious constitutional questions under the federal Due Process Clause. Peregrine chose to incorporate in Delaware and to adopt Delaware law as the law governing the internal affairs of the corporation, including the liability of directors and officers to the corporation. To induce Real Parties to serve as directors, Peregrine represented in its director indemnification agreements, Certificate of Incorporation, by-laws, and public filings that any liability they might have to the corporation would be governed by Delaware law. *See* Ex. 7-E at 285-94; Ex. 7-D at 274; Ex. 7-N at 443. In applying California law to the directors' and officers' duties to their own corporation, the Court of Appeal's decision defeats these legitimate expectations, in violation of the Due Process Clause. *See VantagePoint*, 871 A.2d at 1113; *see also State Farm*, 114 Cal. App. 4th at 444.

The Court of Appeal failed to address these serious issues under the Commerce and Due Process Clauses of the United States Constitution. This omission makes review by this Court of the statutory construction questions here all the more appropriate and important. And unless reviewed and cor-

rected by this Court, the Court of Appeal's interpretation of Corporations Code Section 25502.5 will itself be subject to federal constitutional challenge.

* * * *

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No. 05-1590

FILED

AUG 14 2006

OFFICE OF THE CLERK
SUPREME COURT, U.S.

In the Supreme Court of the United States

JOHN J. MOORES, ET AL.,
Petitioners,

v.

ROBERT C. FRIESE, AS TRUSTEE,
Respondent.

On Petition for a Writ of Certiorari to the Supreme Court of California

RESPONDENT'S BRIEF IN OPPOSITION

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QUESTIONS PRESENTED

1. Whether this Court has jurisdiction to review the interlocutory decision of the California courts.
2. Whether this Court should review federal constitutional issues not raised in Petitioners' demurrers and thus not addressed by any of the California courts.
3. Whether sections 25402 and 25502.5(a) of California's Corporate Securities Law of 1968, which are expressly limited to securities transactions in California, violate either the Commerce Clause or the Due Process Clause of the United States Constitution.

PARTIES TO THE PROCEEDING

Respondent Robert C. Friese is the Trustee of the Peregrine Litigation Trust (the "Trust"). The Trust is the successor in interest to the Estate of Peregrine Systems, Inc. The Trust, by and through Mr. Friese as Trustee, was the plaintiff in the California Superior Court. Mr. Friese, as Trustee, was the petitioner in the Court of Appeal.

Petitioners John J. Moores, Charles E. Noell, III, Norris van den Berg, Christopher A. Cole, and JMI Services, Inc. were defendants in the Superior Court and real parties in interest in the Court of Appeal.

Pursuant to Rule 14.1(b), Respondent states that the following were parties in the California Court of Appeal proceedings, in addition to those named in the caption:

Rodney Dammeyer
Stephen P. Gardner
Matthew C. Gless
Frederic B. Luddy
Richard T. Nelson
Thomas G. Watrous

In the California Superior Court, the following also were parties in addition to those named in the caption:

Richard A. Hosley II
Douglas S. Powanda
William D. Savoy

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In the Supreme Court of the United States

No. 05-1590

JOHN J. MOORES, ET AL.,
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Respondent.

On Petition for a Writ of Certiorari to the Supreme Court of California

RESPONDENT'S BRIEF IN OPPOSITION

Respondent Robert C. Friese respectfully submits this brief in opposition to the petition for a writ of certiorari filed in this case.

OPINIONS BELOW

The order of the Supreme Court of California denying review of the Court of Appeal's decision (Pet. App. 1a-2a) is unreported. The opinion of the Court of Appeal (Pet. App. 3a-26a) is reported at 36 Cal. Rptr. 3d 558 (Cal. Ct. App. 2005). The decision of the Superior Court of California, San Diego County (Pet. App. 27a-31a) is unreported.

JURISDICTION

This Court lacks jurisdiction to review the interlocutory decision of the California courts. That decision is merely an

interim ruling that remands the case for further proceedings (potentially including trial) in the Superior Court. The decision is not a final judgment and does not finally resolve any claims. Petitioners seek to invoke this Court's jurisdiction under 28 U.S.C. § 1257(a), but, as we show in greater detail below, the decision of the California courts does not qualify as a "final judgment or decree" within the meaning of that provision.

STATEMENT OF THE CASE

A. The Parties and History of the Dispute

Petitioners are former officers and directors of Peregrine Systems, Inc. ("Peregrine"), a company that developed and marketed computer software.[1] From 1997 through 2002, Peregrine was a publicly traded Delaware corporation with its headquarters and principal place of business located in San Diego, California. Following its initial public offering in 1997, Peregrine enjoyed substantial success; its annual revenues grew nine-fold from 1997 through the beginning of 2002, and its stock price rose nearly 30-fold from $2.75 per share at its initial public offering to a peak of $79.50 per share in 2000. Petitioners reaped the benefits of the sharp increases in the company's stock price, securing profits of hundreds of millions of dollars from the sales of Peregrine stock. During the summer of 1999, Petitioners collectively sold more than 4.9 million shares of Peregrine stock, and received approximately $120 million in proceeds. During a two-week period in February 2000, Petitioners sold more than 5.3 million shares of Peregrine stock, and received proceeds exceeding $247 million. In the month of February 2001, Petitioners sold more than 3.6 million shares of Peregrine stock and received in excess of $106 million. (Amended Consolidated Complaint at 24-27, 33-36, 48-49.)

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[1] Petitioner JMI Services, Inc. is an investment services firm founded by petitioner John J. Moores.

Much of Peregrine's growth eventually was shown to be the result of pervasive accounting fraud and revenue manipulation. (Pet. App. 9a-11a.) Peregrine had been able to disguise the deterioration of its direct sales by adopting a disfavored accounting method that allowed it to record sales as its products entered the distribution stream, as opposed to when a product was sold to an end-user. In essence, and in the words of its CEO, Peregrine was "borrowing [revenue] from the future" to meet Wall Street expectations. (Amended Consolidated Complaint at 46.) Peregrine's public announcements and Securities and Exchange Commission filings made no mention of these behind-the-scenes machinations. (Pet. App. 10a-11a.) From the perspective of the public and Peregrine's shareholders, Peregrine was meeting or exceeding expectations.

In May 2002, Peregrine finally announced that its earnings had been substantially overstated as a result of the accounting fraud. Peregrine's stock price plummeted, bottoming out at 89 cents per share. Peregrine filed for bankruptcy in September 2002. The bankruptcy proceedings revealed that Peregrine had overstated its profits by more that $500 million, or 38 percent, during the period from April 1999 through December 2001. (Pet. App. 11a.)[2]

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[2] Petitioners rely on a Latham & Watkins Report of Investigation to support their assertion that they were absolved of any wrongdoing connected to the accounting fraud. (Pet. 7.) The Latham & Watkins report, which is not part of the trial court record, is not relevant here. On a demurrer, the allegations set forth in the complaint are presumed to be true; on review, the court is limited to the allegations and matters that are properly the subject of judicial notice. *See Labadie v. California*, 256 Cal. Rptr. 604, 605 (Cal. Ct. App. 1989). Petitioners will have the opportunity to litigate their complicity in the accounting fraud on remand. In the meantime, it is worth noting that Petitioners themselves commissioned the Latham & Watkins report, and their trial counsel participated in its preparation.

The Peregrine Litigation Trust was formed as part of the Peregrine bankruptcy reorganization plan. The bankruptcy estate assigned any claims Peregrine might have against its officers and directors to the Litigation Trust. Respondent Robert C. Friese is the Trustee of the Peregrine Litigation Trust.

B. The Trial Court Proceedings

In February 2004, Respondent Friese, pursuing claims assigned by Peregrine to the Litigation Trust, substituted in as plaintiff in a consolidated action against Petitioners and filed an amended complaint in the San Diego Superior Court. The complaint states ten causes of action against fourteen individual defendants, primarily Peregrine's senior officers and directors, and several trusts controlled by petitioner John J. Moores.[3] (Pet. App. 9a n.2.) The complaint alleges statutory claims for violations of California's insider trading laws, *i.e.*, California Corporations Code §§ 25402 and 25403, and common law claims for breach of the duty of loyalty, breach of the duty of care, waste of corporate assets, conspiracy, and unjust enrichment. (Pet. App. 11a.) The petition in this Court relates only to the statutory insider trading claims; the common law claims remain pending in the trial court.[4]

California Corporations Code § 25402[5] prohibits corporate insiders from purchasing or selling securities in the State of California while possessing non-public material information at a time when the material information would significantly affect the market price of the security. Section 25502.5(a)

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[3] Petitioner Moores was named as a defendant individually and as trustee of twenty-two separate trusts.

[4] The trial court sustained defendants' demurrers challenging the five common law causes of action, but granted Respondent Friese leave to amend all five claims to plead additional facts.

[5] All further statutory references are to the California Corporations Code unless otherwise indicated.

authorizes a corporation or "issuer" to sue for violations of section 25402, thereby adding such suits to investor actions and civil actions or criminal prosecutions by public authorities as means for enforcing the ban against insider trading in California. In support of the statutory insider trading claims in this case, the complaint alleges that when Petitioners sold their Peregrine stock they were aware of material adverse developments in the company not known to the investing public. With this material, nonpublic information in hand, Petitioners sold or transferred stock in California for their personal benefit at artificially inflated prices. (Pet. App. 11a-12a & n.4.)

The various defendants proceeded differently in response to the complaint. Some filed demurrers presenting fully briefed arguments, others briefed only particular arguments directed at select claims and purported to join in the other briefs, and still others argued nothing and merely filed "joinders."

Petitioners Moores and JMI filed a joint demurrer and supporting memorandum of points and authorities. They challenged, *inter alia*, the statutory insider trading claims (counts one through five of the Amended Consolidated Complaint).[6] (Amended Demurrers of Defendants John J. Moores and JMI Services, Inc.) They argued, in relevant part, (1) that Delaware law should govern the insider trading claims because the claims belonged to Peregrine, a Delaware corporation, and, therefore, under the internal affairs doctrine and section 2116,[7] the law of the state of incorporation should control,

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[6] Under California Code of Civil Procedure § 430.50, a demurrer to a complaint "may be taken to the whole complaint . . . or to any of the causes of action stated therein."

[7] Section 2116 provides that the liability of directors of a foreign corporation for violations of "official duty" while transacting business in California is governed by the law of the state of incorporation.

(2) that the complaint fails to allege a cause of action for insider trading under Delaware common law, and (3) that even if California law applied to the securities claims, the complaint fails to state a claim because it does not plead with particularity that defendants (a) knew material information, or (b) sold the stock within the meaning of section 25402.

Petitioners Noell and van den Berg filed a joint memorandum of points and authorities arguing in relevant part that the complaint fails to allege sufficient facts in support of the insider trading claims, and stating in a footnote that they joined in the arguments asserted by Moores and JMI. (Amended Demurrers of Defendants Charles E. Noell, III, Norris van den Berg, and Richard A. Hosley II at 1 n.1, 4, 16.) Petitioner Cole merely filed a joinder in Moores' and JMI's demurrer, stating: "The demurrers in which Cole joins have been made pursuant to *California Code of Civil Procedure* § 430.10(e) and (f), on the grounds that each of the . . . purported causes of action [asserted against Cole] in the Amended Consolidated Complaint fail[s] to set forth sufficient facts to state a cause of action and that the pleading is uncertain." (Joinder by Defendant Christopher A. Cole in Demurrer filed by John J. Moores.)

In all of these hundreds of pages of filings, the only remote hint of a federal constitutional question came in the form of a footnote in petitioners Moores' and JMI's demurrer in which they sought to "reserve all other objections to the purported claims under Cal. Corp. Code § 25502.5, even if not asserted herein." (Pet. App. 34a.)

The trial court sustained Petitioners' demurrers to the statutory insider trading claims. The court held, as a matter of California law, that section 2116 and the internal affairs doctrine require application of Delaware law because "Delaware law governs the relationship between Peregrine and its directors and/or officers." (Pet. App. 29a.) Having held that Delaware law governs, the court's order did not address Peti-

tioners' alternative arguments regarding whether the allegations in the complaint set forth facts sufficient to support a section 25402 claim. (*Id.*)

C. The Court Of Appeal Proceedings

Respondent Friese filed a petition for peremptory writ of mandate with the California Court of Appeal, contending that the trial court erred by disregarding California's securities laws and controlling precedent, both of which compelled application of California law. The Court of Appeal granted the petition in a decision filed December 2, 2005 (Pet. App. 5a-26a), and amended December 29, 2005 (Pet. App. 4a) and January 24, 2006 (Pet. App. 3a).

Before granting the writ of mandate, the Court of Appeal issued an order to show cause requesting briefing from Petitioners, the real parties in interest. (Pet. App. 8a.) Petitioners primarily defended the trial court's reading of section 2116 and the application of Delaware law, but they also unveiled their constitutional arguments for the first time. Ultimately, the court ruled in favor of Respondent's interpretation of California's securities laws and held that the "securities laws are designed to protect participants in California's securities marketplace and deter unlawful conduct which takes place [in California]." (Pet. App. 8a.) Accordingly, the California securities laws in general, and section 25502.5 in particular, govern conduct occurring in California regardless of where the issuer of the securities is incorporated. (*Id.*) The court did not address Petitioners' newly minted constitutional arguments.

In determining the scope of California's insider trading provisions, the Court of Appeal reviewed the history and application of California's securities regulations system. "For the last 100 years California's corporate securities laws have been applied to foreign corporations who do business in [California] or whose activities in [California] have an impact

on [California's] securities market." (Pet. App. 12a.) To supplement the federal regulation of insider trading, California enacted the Corporate Securities Law of 1968, which included section 25402. (Pet. App. 17a.) California's "prohibition on insider trading was adopted as a means of protecting investor confidence in the securities market and more broadly as a means of punishing what is perceived by the public as immoral conduct." (Pet. App. 25a.) By its terms, section 25402 is limited to securities transactions that occur in California. The California Legislature determined "that the basis of jurisdiction and regulation should be the offer or sale of securities in [California] and *should not be related to the principal place of business or corporate domicile*." (Pet. App. 17a (italics added by court; internal quotation marks omitted).)

As the Court of Appeal explained, several remedies exist for violations of section 25402. For example, section 25502 provides a civil right of action to private plaintiffs duped by insiders engaged in purchasing and selling securities in California in violation of section 25402 (Pet. App. 17a-18a). In 1988, following the "discovery of persistent, systematic insider trading activities yielding millions of dollars in profit to well-known securities professionals" (Pet. App. 16a (internal quotation marks omitted)), the California Legislature added section 25502.5 to provide the same right of action to the issuer of the stock (Pet. App. 18a-19a). The Legislature thus sought to deter insider trading activities in California rather than merely to provide monetary recovery for losses sustained. (Pet. App. 19a.) As the Court of Appeal recognized, the corporation or issuer of stock typically does not suffer money damages when one of its insiders engages in insider trading. "Thus in compelling an officer or director to disgorge to an issuer profits realized by way of insider trading, section 25502.5 does not provide the issuer with compensation for any lost opportunity the issuer itself could have lawfully realized." (Pet. App. 25a-26a.) "The deterrence

provided by this provision clearly demonstrates that in enacting section 25502.5, the Legislature was very much concerned about discouraging conduct it found destructive to the public interest." (Pet App. 26a.)

The court then turned its attention to Petitioners' argument that section 2116 and the internal affairs doctrine prohibit a Delaware corporation from invoking section 25502.5 against its own officers and directors. The internal affairs doctrine is "a conflict of laws principle" under which the internal affairs of a corporation are regulated by the laws of one state to avoid conflicting demands on the corporation. Typically, the laws of the state of incorporation govern. As applied to director's liability, section 2116 is a codification of the internal affairs doctrine. (Pet. App. 20a.) In this regard, the court agreed with Petitioners—"the duties officers and directors owe a corporation are in the first instance defined by the law of the state of incorporation." (Pet. App. 8a.) The court correctly recognized, however, that those duties "are not the subject of California's corporate securities laws in general or section 25502.5 in particular." (Pet. App. 8a.)

Relying on *State Farm Mut. Auto. Ins. v. Superior Court*, 8 Cal. Rptr. 3d 56, 64 (Cal. Ct. App. 2003), the court stated (Pet. App. 20a):

> "Internal affairs" include steps taken in the course of the original incorporation, . . . the adoption of by-laws, the issuance of corporate shares, the holding of directors' and shareholders' meetings, . . . and the declaration and payment of dividends and other distributions, charter amendments, mergers, consolidations, and reorganizations, the reclassification of shares and the purchase and redemption by the corporation of outstanding shares of its stock.

The internal affairs doctrine thus does not govern every issue or dispute involving a corporation's officers or directors. In particular, the Court of Appeal observed, the doctrine does

not preclude enforcement of a forum state's corporate securities laws. (Pet. App. 21a.) Citing Section 309 of the Restatement of Conflicts Second, the court pointed to a state's "blue sky laws" as a common example of state securities regulation that is not displaced by the internal affairs doctrine. (Pet. App. 22a, *quoting* Restatement (Second) of Conflicts § 309 cmt. a (1971).) There is, in short, no incompatibility between the internal affairs doctrine and state insider trading laws like section 25502.5. The internal affairs doctrine addresses the relationship between a corporation and its officers and directors acting within their official capacities; laws like section 25502.5 are triggered when an officer or director steps outside of the bounds of his official duties and engages in insider trading in the State of California to the detriment of the California public and California's securities marketplace.

The Court of Appeal concluded that Petitioners and the trial court failed to appreciate this distinction. The insider trading proscribed by California's statute—the purchase or sale of stock in California for personal profit, at a time when an officer or director has material, non-public information regarding the company—necessarily falls outside the scope of an official corporate duty; it is not part of a corporation's internal affairs. The Court of Appeal explicitly rejected Petitioners' characterization of section 25502.5 "as merely a device for enforcing directors' and officers' fiduciary duties to shareholders." (Pet. App. 25a.) Section 25502.5 neither compensates the corporation for any losses experienced nor provides a means to recover any lawful corporate opportunity. Accordingly, a corporation's claim under the statute is distinct from a derivative breach of fiduciary duty claim. Rather, it "is very much a part of California's corporate securities regulation scheme and serves broad public interests [of deterrence] rather than the more narrow interests of a corporation's shareholders." (Pet. App. 26a.)

Contrary to Petitioners' assertion (Pet. 10-11), the Court of Appeal *did not* disregard the internal affairs doctrine, nor attempt to reach across state lines to tell an out-of-state corporation how to order relationships among the corporation and its directors, officers, and shareholders. The court merely determined that California is entitled to adopt appropriate measures to deter and remedy insider trading violations in California securities transactions.

The court's unanimous decision concluded that a writ of mandate should issue directing the trial court to vacate its order sustaining Petitioners' demurrers to the statutory claims. Under the court's ruling, the trial court now must conduct further proceedings on those claims consistent with the Court of Appeal's opinion. (Pet. App. 26a, 4a.)

The Court of Appeal denied Petitioners' request for rehearing. (Pet. App. 4a.) The California Supreme Court then denied Petitioners' petition for review. (Pet. App. 2a.)

ARGUMENT

Although one would hardly know it from the petition, this is an insider trading case. The conduct at issue involves the trading of stock in California for personal profit. Enacted as part of California's Securities Law of 1968, California Corporations Code § 25402 forbids an "officer, director or controlling person of an issuer" from "purchas[ing] or sell[ing] any security of the issuer in [the State of California] at a time when he knows material information about the issuer gained from such relationship which would significantly affect the market price of that security and which is not generally available to the public." Several enforcement mechanisms provide for actions by investors, civil regulators, and prosecutors. *See, e.g.*, § 25502 (providing private investors a right of action); § 25530 (providing for action by the State Attorney General or Commissioner of Corporations); § 25540 (providing for felony criminal penalties). In 1988,

the California Legislature added to this list suits by the corporate issuer of the relevant security. Section 25502.5 authorizes a corporation to pursue civil sanctions for violations of section 25402. By providing for multiple forms of liability and the possibility of treble damages, the Legislature has put in place several substantial disincentives designed to curb insider trading. Petitioners do not challenge California's prohibition against insider trading in California (section 25402) or any of the remedial provisions allowing actions by shareholders, civil regulators, or criminal prosecutors. Indeed, they concede (Pet. 20) that all of these provisions (and perhaps others as well) are entirely appropriate. Petitioners contend, however, that the Commerce Clause and the Due Process Clause prohibit a state from authorizing a *corporation* to pursue a cause of action against insider trading of the corporation's own securities. In an effort to justify their argument, Petitioners repeatedly mischaracterize the Court of Appeal's holding and the true nature of the claims involved. (*See, e.g.*, Pet. at 2, 10, 14, 20, referring to section 25502.5 claim as a breach of fiduciary duty claim despite explicit rejection of this argument by Court of Appeal; Pet. at 3, 9, 13, stating, in direct contradiction to the court's actual holding, that the court below interpreted section 25502.5 as governing a Delaware corporation's internal affairs.)

Not surprisingly, Petitioners offer no support for their premise that an officer or director acts in his official capacity when he engages in insider trading or sells his own stock for personal gain. (*See, e.g.*, Pet. at 20: "What is at issue here is whether California may abrogate the internal affairs doctrine by permitting an out-of-state corporation to sue its own directors and officers *for conduct in their official capacities* in order to promote California's 'broad public interest.'" (emphasis added).) Without this erroneous premise, Petitioners' attacks on section 25502.5 disintegrate.

The Court of Appeal properly rebuffed Petitioners' attempt to distort California's statutory liability for insider trading into a common law breach of fiduciary duty claim. The internal affairs doctrine "concerns the corporation's organic structure or internal administration." Restatement (Second) of Conflicts § 313 cmt. c (1971). As the Court of Appeal correctly concluded, an officer's or director's misdeeds related to his or her personal sales of stock play no role in the corporation's internal affairs. Because the relevant stock sales took place in the State of California, California properly could apply to the transactions the State's prohibition against insider trading and its remedies for such conduct.

Even apart from the merits, however, the petition faces serious problems. First, this Court currently lacks jurisdiction because the petition seeks review of an interlocutory decision that is not a final judgment within the meaning of 28 U.S.C. § 1257(a). No claim has been finally resolved, and further proceedings are needed in the trial court before any liability can be imposed. Petitioners have denied engaging in any insider trading, and, if their position is sustained in the California courts, their proposed federal constitutional issues will be moot. Second, the federal questions presented are not suitable for review at this stage because Petitioners voluntarily chose not to assert their Commerce Clause and Due Process Clause arguments in their demurrers in the trial court. As a result, none of the state courts actually has addressed Petitioners' constitutional challenges to California's statute. This Court normally will not grant review in these circumstances, and there is no reason to make an exception here.

Putting aside these difficulties, the Court of Appeal's decision is correct and further review is not warranted. The Court of Appeal followed the clear language and intent of California's securities laws, applied controlling precedent, and enforced California's important prohibition against insider trading. Petitioners cite no decision that suggests that a

State's regulation of insider trading within its borders runs afoul of the Commerce Clause or Due Process Clause, or that an officer's or director's personal stock trading is an official duty governed by the internal affairs doctrine and not the forum state's securities regulations.

I. THIS COURT LACKS JURISDICTION TO REVIEW THE INTERLOCUTORY DECISION OF THE CALIFORNIA COURTS.

This Court lacks jurisdiction to review non-final, interlocutory orders of state courts. The interlocutory writ of mandate issued by the California Court of Appeal (and left undisturbed by the California Supreme Court) is just such an order.[8]

Under 28 U.S.C. § 1257(a), this Court's review of state court decisions is confined to "[f]inal judgments or decrees rendered by the highest court of a State in which a decision could be had . . . where the validity of a statute of any State is drawn in question on the ground of its being repugnant to the Constitution." To be eligible for review by this Court, a case must be final in two regards: "it must be subject to no further review or correction in any other state tribunal; it must also be final as an effective determination of the litigation and not of merely interlocutory or intermediate steps therein." *Jefferson v. City of Tarrant*, 522 U.S. 75, 81 (1997) (quoting *Market St. R. Co. v. R.R. Comm'n of Cal.*, 324 U.S. 548, 551 (1945)). In other words, to come within the jurisdiction conferred by section 1257(a), the decision for which review is sought "must be the final word of a final court." *Market St.*

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[8] Writ review in California is by definition interlocutory; it provides a supplementary system for appellate court review of otherwise non-appealable trial court rulings. Unlike traditional appeals, writ review is deemed extraordinary, equitable, and completely discretionary. *See generally Omaha Indem. Co. v. Superior Court*, 258 Cal. Rptr. 66 (Cal. Ct. App. 1989) (explaining the purpose and appropriate use of the court's discretionary exercise of power to grant writ relief).

R. Co., 324 U.S. at 551; *see also Radio Station WOW, Inc. v. Johnson*, 326 U.S. 120, 123-24 (1945) ("This prerequisite to review derives added force when the jurisdiction of this Court is invoked to upset the decision of a State court."); *Collins v. Miller*, 252 U.S. 364, 370 (1920) (the judgment "should be final not only as to all the parties, but as to the whole subject-matter and as to all the causes of action involved").

The decision of the California courts here is not "an effective determination of the litigation." *Jefferson*, 522 U.S. at 81. Far from terminating the litigation, the Court of Appeal resolved a single issue that affected only five of the ten causes of action in Respondent's complaint. Upon overturning the trial court's dismissal of those five counts, the Court of Appeal remanded the case for further proceedings consistent with its order. Absent settlement or further dispositive motions, the proceedings on remand will include a trial on the merits and, more than likely, further appeals. Because only one aspect of the case has been adjudicated in the courts below, "none of it is ripe for review by this court." *Collins*, 252 U.S. at 350. Because the California Court of Appeal "remanded this case for trial, its decision is not final as an effective determination of the litigation." *O'Dell v. Espinoza*, 456 U.S. 430, 430 (1982) (per curiam) (internal quotation marks omitted).

This litigation is ongoing. The trial court granted Respondent leave to amend the five common law causes of action (Pet. App. 30a-31a), and the Court of Appeal reinstated the five statutory insider trading claims (Pet. App. 26a, 4a). Accordingly, as the case comes to this Court, it has not progressed beyond the pleading stage. The underlying facts have yet to be developed, and the trial court has yet to review Petitioners' defenses.

The finality requirement "is not one of those technicalities to be easily scorned. It is an important factor in the smooth working of our federal system." *Jefferson*, 522 U.S. at 81

(quoting *Radio Station WOW*, 326 U.S. at 124). Finality "avoids piecemeal review of state court decisions; it avoids giving advisory opinions in cases where there may be no real 'case' or 'controversy' in the sense of Art. III; it limits review of state court determinations of federal constitutional issues to leave at a minimum federal intrusion in state affairs." *N.D. State Bd. of Pharmacy v. Snyder's Drug Stores, Inc.*, 414 U.S. 156, 159 (1973). The finality requirement additionally "serves an important interest of comity" between the state and federal courts. *Adams v. Robertson*, 520 U.S. 83, 90 (1997) (per curiam) (dismissing writ of certiorari as improvidently granted).

Nor does this case fall within any of the four categories of exceptional cases in which this Court has treated state-court judgments as final for jurisdictional purposes even though further proceedings were to take place in the state court. *See Cox Broadcasting Corp. v. Cohn*, 420 U.S. 469, 479-84 (1975). The first three categories are inapplicable on their face. *See id.*

First, the federal questions Petitioners attempt to raise here are not "conclusive" nor is the outcome of the proceedings "preordained." *Id.* at 479. Unlike the situation in *Mills v. Alabama*, 384 U.S. 214 (1966), the "prototypical example of this category," *Florida v. Thomas*, 532 U.S. 774, 778 (2001), the further proceedings (including trial) contemplated by the Court of Appeal's opinion will consist of "more than a few formal gestures leading inexorably towards" the predetermined end result. *Mills*, 384 U.S. at 217. Unlike Mr. Mills, Petitioners have not acknowledged that they engaged in the conduct prohibited by state law.

Second, this is not a case in which "the federal issue, finally decided by the highest court of the State, will survive and require decision regardless of the outcome of the future state-court proceedings." *Cox*, 420 U.S. at 480. If Petitioners prevail on their remaining legal and factual arguments, judg-

ment will be entered in their favor, and their federal constitutional issues will be moot.

Third, this case is not one "where the federal claim has been finally decided, with further proceedings on the merits in the state courts to come, but in which later review of the federal issue cannot be had, whatever the ultimate outcome of the case." *Cox*, 420 U.S. at 481. Petitioners remain free to raise their constitutional objections in the trial court, and if judgment is entered in favor of Respondent Friese and against Petitioners, Petitioners may appeal those issues as of right to the California Court of Appeal followed by discretionary review in the California Supreme Court. Thus, the California courts' ultimate "determination will in no way limit [this Court's] ability to review the issue on final judgment." *Jefferson*, 522 U.S. at 84.

The fourth *Cox* category also is inapplicable. Denying review of the decision below will not "seriously erode federal policy" because no immediate or systematic consequences will result from such a delay. Rather, any potential review "can await final judgment without any adverse effect upon important federal interests." *Flynt v. Ohio*, 451 U.S. 619, 622 (1981) (per curiam) (declining to adopt an expansive construction of the exceptions set forth in *Cox*—particularly this fourth exception—that would "swallow the rule" requiring a final judgment).

This case presents "the typical situation in which the state courts have resolved some but not all of petitioners' claims. [This Court's] jurisdiction therefore founders on the rule that a state-court decision is not final unless and until it has effectively determined the entire litigation." *Jefferson*, 522 U.S. at 84.

II. BECAUSE PETITIONERS' CONSTITUTIONAL ARGUMENTS WERE NOT PRESENTED IN THE STATE COURT DEMURRERS, THEY WERE NOT ADDRESSED BY THE COURTS BELOW AND ARE NOT SUITABLE CANDIDATES FOR REVIEW HERE.

Because Petitioners voluntarily elected not to raise their Commerce Clause and Due Process Clause arguments in the trial court, none of the California courts have addressed those arguments, and review in this Court is not warranted. In the Superior Court, the only alleged inkling of Petitioners' constitutional issues came in the form of a footnote in Moores' and JMI's joint demurrer purporting to "reserve all other objections." (Pet. App. 34a-35a.) None of the other Petitioners included any similar footnote, much less properly presented any constitutional arguments in opposition to the application of California law. The most they can point to is the jumble of cross-joinders filed below.

Not surprisingly, given Petitioners' failure to argue the point, the trial court did not address any constitutional issue nor was it obliged to do so. *See* Cal. C. Civ. P. § 430.60 (requiring that a demurrer to a complaint "distinctly specify the grounds upon which any of the objections to the complaint . . . are taken," and authorizing a trial court to "disregard" arguments not properly asserted); Cal. C. Civ. P. § 1010 (requiring a party to state in the notice of motion the grounds upon which the motion will be based); Cal. Rules of Court 311(a) ("A notice of motion shall state in the opening paragraph . . . the grounds for issuance of the order."); *Luri v. Greenwald*, 132 Cal. Rptr. 2d 680, 684-85 (Cal. Ct. App. 2003) (setting forth the general rule in California that "a trial court may consider only the grounds stated in the notice of motion").

The case came to the Court of Appeal on interlocutory writ review, where the Court of Appeal's function is to review the

trial court's order. Petitioners' failure to assert any constitutional issue before the trial court thus set in motion two subsequent layers of review in the California courts directed solely at the issues properly presented at the outset. Petitioners' Commerce Clause and Due Process Clause arguments were not among those issues.

This Court ordinarily does not decide questions "not pressed or passed upon below." *Duignan v. United States*, 274 U.S. 195, 200 (1927). The Court will grant review of such a question "only in exceptional cases." *Id.* This is not an "exceptional case." As a result of Petitioners' failure, not one of the three state courts to review the arguments in this case passed on the merits of the questions presented here by Petitioners. "[W]hen, as here, the highest state court has failed to pass upon a federal question, [this Court] assume[s] that the omission was due to want of proper presentation in the state courts . . . ." *Street v. New York*, 394 U.S. 576, 582 (1969). The party invoking the Court's jurisdiction under these circumstances "has the high burden of showing that the federal question was in fact properly raised." Robert L. Stern et al., SUPREME COURT PRACTICE 175 (8th ed. 2002). Petitioners, having chosen what they wished to include in their demurrers, are unable to meet that high burden. As this Court admonished in *Ackermann v. United States*, 340 U.S. 193, 198 (1950), "free, calculated, deliberate choices are not to be relieved from." Like the petitioner in *Ackermann*, Petitioners should not be relieved from the consequences of their voluntary choice not to raise any constitutional arguments in the trial court.

III. NEITHER THE COMMERCE CLAUSE NOR THE DUE PROCESS CLAUSE PREVENTS THE CALIFORNIA LEGISLATURE FROM SEEKING TO DETER AND REMEDY INSIDER TRADING IN CALIFORNIA BY GRANTING A CAUSE OF ACTION TO THE CORPORATION WHOSE SECURITIES WERE UNLAWFULLY PURCHASED OR SOLD IN CALIFORNIA.

Even putting aside all of the procedural infirmities, Petitioners' arguments on the merits are unavailing. In an effort to demonstrate that California law, namely section 25502.5, as interpreted by the California courts, violates the Commerce Clause and Due Process Clause, Petitioners begin with the faulty premise that sections 25402 and 25502.5 regulate the official duties of corporate officers and directors. The Court of Appeal properly rejected this argument, and Petitioners offer no support for it here. Nor is there any reason to think that it is part of the official duty of a corporate officer or director to purchase or sell stock in California for personal gain.

Sections 25402 and 25502.5 proscribe insider trading in the State of California. These provisions are aimed at protecting California's "legitimate and compelling interest in preserving a business climate free of fraud" and curbing deceptive practices in the State. *Diamond Multimedia Sys., Inc. v. Superior Court*, 19 Cal. 4th 1036, 1064 (Cal.), *cert. denied*, 527 U.S. 1033 (1999). The California Legislature enacted section 25502.5 in an effort to send a "loud and clear message":

> Inside trading on the securities market is a very serious crime, and yet the current civil and criminal penalties amount to no more than a slap on the wrist for those who commit this crime. Senate Bill 2578 sends a loud and clear message to "would be" inside traders that such practices will not be tolerated in California.

S.B. 2578, Floor Statement, 1987-88 Reg. Sess. (Cal. 1988).

Recognizing that corporations have a significant interest in protecting California's securities marketplace and maintaining California investor confidence, the Legislature deputized the issuer corporation to assist in deterring insider trading in the corporation's securities in California. Section 25502.5 authorizes the corporation to enforce section 25402 against *any* violator whose relationship with the issuer provides access to non-public, material information. The statute in essence creates a private attorney general mechanism and provides an incentive in the form of treble damages to encourage corporations to assist in the enforcement and regulation of the State's securities market.

Because sections 25402 and 25502.5 regulate only conduct occurring within California, they do not discriminate against or impose an impermissible burden on interstate commerce "by subjecting activities to inconsistent regulations." *See CTS Corp. v. Dynamics Corp.*, 481 U.S. 69, 88 (1987); *see also Diamond Multimedia Sys.*, 19 Cal. 4th at 1064 (rejecting Commerce Clause challenge to related securities provisions, sections 25400 and 25500). States may regulate in-state portions of interstate transactions as long as the regulation furthers a legitimate state interest. *See Pike v. Bruce Church, Inc.*, 397 U.S. 137, 142 (1970). Any indirect burden that these securities provisions place on out-of-state commerce "is clearly offset by the state interest in preventing fraud and protecting the integrity of the capital market for all investors." *Diamond Multimedia Sys.*, 19 Cal. 4th at 1064. Even Petitioners agree that "the Commerce Clause is not offended" by a State's application of its blue-sky laws to securities issued by an out-of-state corporation but sold within the State. (Pet. 19.)

Petitioners' due process challenge is equally flawed. Petitioners contend that they "could not possibly have anticipated the novel California liability" they have encountered as a result of their unlawful conduct. (Pet. 21.) That is an odd

contention indeed, given that the challenged California statutory provision was enacted a decade before the trading at issue. Petitioners concede, moreover, that "California is of course free to pursue its [interests] against insider trading through any number of . . . mechanisms" contained within the Corporations Code. (Pet. 20.) Petitioners' illicit behavior in California subjected them to liability in California, regardless of whether the plaintiff holding them accountable is the California Attorney General, the California Securities Commissioner, a private investor, or the issuer corporation. Petitioners' alleged subjective belief that they could not be sued on behalf of Peregrine under California law, apart from being entirely self-serving, cannot create a due process violation or otherwise inoculate Petitioners against the application of California law to securities transactions in California.

Finally, there is no conflict among the circuits with regard to either of the issues that Petitioners seek to present, no conflict with general federal policy, and no conflict with any decision of this Court. Petitioners' principal thesis is that tensions exist between California and Delaware decisions concerning the interpretation of the internal affairs doctrine. (Pet. 10.) Any such tension is not at issue here, primarily because the Court of Appeal correctly concluded that the internal affairs doctrine has no application to private securities trading and enforcement of a state's corporate securities laws.

Relying solely on *VantagePoint Venture Partners 1996 v. Examen, Inc.*, 871 A.2d 1108 (Del. 2005), for their purported conflict, Petitioners look to find disagreement where none exists. The court in *VantagePoint* did not even suggest, much less hold, that section 25502.5 violates the Constitution. Indeed, as Petitioners concede, *VantagePoint* "involves a different provision of the California Corporations Code;" the Delaware courts have not addressed the provisions at issue here. (Pet. 13.) On the contrary, the Delaware and California

courts are in agreement where there is any overlap in their analysis.

Both the *VantagePoint* court and the California courts recognize and, when relevant follow, the internal affairs doctrine. The court in *VantagePoint* was asked whether a shareholder of preferred stock had a right to vote by separate class of stock regarding a corporate merger. The court had no difficulty determining that "the legal issue in this case . . . clearly involves the relationship among a corporation and its shareholders." 871 A.2d at 1115-16. As a result, the court relied on the internal affairs doctrine in the remainder of its analysis.

Here, by contrast, the California Court of Appeal correctly concluded that the internal affairs doctrine "does not apply to individual transactions between a director and . . . shareholder, such as where a director purchases shares from the shareholder for his personal account." Restatement (Second) of Conflicts § 309 cmt. a (1971). Faced with allegations of personal stock sales for personal gain, the court properly determined that this behavior does not implicate internal corporate affairs or the official duties of a corporate officer or director, and thus is not governed by the internal affairs doctrine. (Pet. App. 24a-26a.)

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted,

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IN THE

Supreme Court of the United States

JOHN MOORES, *et al.*,
Petitioners,

v.

ROBERT C. FRIESE,
Respondent.

On Petition for a Writ of Certiorari to the California Court of Appeal, Fourth Appellate District, Division One

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Respondent spends little time on the merits of the Petition's constitutional arguments, *see* Opp. 20-23, resting principally instead on the arguments that this Court lacks jurisdiction to review them and that they were not presented to the state courts below. Both assertions are incorrect.

First, this Court has jurisdiction to review the decision below. Under *Cox Broadcasting Corp. v. Cohn*, 420 U.S. 469 (1975), the Court of Appeal's decision should be treated as a final judgment for purposes of determining this Court's jurisdiction under 28 U.S.C. § 1257(a). The California Court of Appeal, with review denied by the California Supreme Court, has determined with finality that Section 25502.5 applies to foreign corporations, and a decision in Petitioners' favor would determine the outcome in this case. Second, Petitioners pressed their constitutional arguments in the courts below, arguing at every level that application of California Corporations Code Section 25502.5 to foreign corporations would violate the Commerce and Due Process Clauses of the federal Constitution. Petitioners should not be penalized for the state courts' failure to address their federal constitutional claims.

Respondent's arguments on the merits are no more availing. The Court of Appeal's decision creates a clear tension between California and Delaware law regarding federal constitutional limits on one State's ability to "deputize" an out-of-state corporation as a "private attorney general" to serve that State's own idiosyncratic policy interests. The amicus brief filed in support of Petitioners vividly depicts the uncertainty and confusion the decision below has created for the nation's corporations and their officers and directors doing business across state lines. *See* Brief of Amici Curiae Technology Network, *et al.* in Support of Petitioners, filed August 14, 2006. Review by this Court is warranted.

I. THE COURT HAS JURISDICTION UNDER 28 U.S.C. § 1257

The California courts have ruled definitively that California Corporations Code Section 25502.5 may be extended across state lines to govern the internal affairs of Delaware and other foreign corporations. Contrary to Respondent's suggestion that review should await the final word of a final state court, Opp. 14-16, this Court need not await the completion of additional proceedings anticipated in the lower courts. This Court "has recurringly encountered situations in which the highest court of a State has finally determined the federal issue present in a particular case, but in which there are further proceedings in the lower state courts to come." *Cox Broadcasting Corp. v. Cohn*, 420 U.S. 469, 477 (1975). As in many of those situations, the Court should treat the judgment below as a final judgment for purposes of 28 U.S.C. § 1257.

Cox Broadcasting expressly contemplated, as its fourth category of such situations, that a state-court judgment will be treated as final

> where the federal issue has been finally decided in the state courts with further proceedings pending in which the party seeking review . . . might prevail on the merits on nonfederal grounds, thus rendering unnecessary review of the federal issue by this Court, and *where reversal of the state court on the federal issue would be preclusive of any further litigation on the relevant cause of action* rather than merely controlling the nature and character of, or determining the admissibility of evidence in, the state proceedings still to come. . . . [I]f a refusal immediately to review the state court decision might seriously erode federal policy, the Court has entertained and decided the federal issue . . . .

Id. at 482-83 (emphasis added).

This case aptly fits that category. California's state courts have finally and unconstitutionally decided to apply Section 25502.5 to foreign corporations. The published California Court of Appeal opinion holding that Section 25502.5 governs claims by Delaware and other foreign corporations against their own directors and officers is now the definitive interpretation of Section 25502.5. The California Supreme Court summarily denied Petitioners' petition for review. There is no other California state-court decision interpreting Section 25502.5.

Consistent with the fourth *Cox Broadcasting* category, a reversal of the Court of Appeal's decision on constitutional grounds would preclude any further litigation on those causes of action. Indeed, reversal of the Court of Appeal's decision on constitutional grounds might well preclude years of complex litigation and trial altogether. Respondent concedes that its alternative claim challenging Petitioners' stock trades under Delaware law requires proof of scienter, *see* Pet. App. 30a, and a federal district court has already concluded that claims by Respondent's beneficiaries based on the same set of facts failed to allege Petitioners' scienter as a matter of law. *See In re Peregine Systems, Inc., Securities Litigation*, No. 02 CV 870-BEN (RBB) (S.D. Cal. March 30, 2005).[1]

Treatment of the Court of Appeal's decision as final thus would serve this Court's "pragmatic approach" to the finality

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[1] Respondent repeatedly invokes the misleading characterization that "this is an insider trading case." *See, e.g.*, Opp. 11. Respondent neglects to mention, however, that no court and no government official has ever credited Respondent's claims. To the contrary, when Respondent's beneficiaries asserted federal securities fraud claims against Petitioners in a class-action complaint, including the very same allegations about stock sales, a federal district court dismissed those claims on the pleadings. *See In re Peregrine, supra.* The district court noted specifically that that there was nothing suspicious about the amount or timing of any of Petitioners' stock sales. *See id.* at 100-08.

requirement, and the policy of preventing economic waste and delayed justice that underlies it. *See Shaffer v. Heitner*, 433 U.S. 186, 195 n.12 (1977) ("'[Appellants] may prevail at trial on nonfederal grounds, it is true, but if the (Delaware) court erroneously upheld the statute, there should be no trial at all.'"); *Mercantile Nat'l Bank v. Langdeau*, 371 U.S. 555, 558 (1963) ("[I]t serves the policy underlying the requirement of finality in 28 U.S.C. § 1257 to determine now in which state court appellants may be tried rather than to subject them, and appellee, to long and complex litigation which may all be for naught if consideration of the preliminary question of venue is postponed until the conclusion of the proceedings."); *Cox Broadcasting*, 420 U.S. at 477-78 ("[I]mmediate rather than delayed review would be the best way to avoid 'the mischief of economic waste and of delayed justice.'") (quoting *Radio Station WOW, Inc. v. Johnson*, 326 U.S. 120, 124 (1945)).

Further, review of the Court of Appeal's decision is appropriate because "refusal immediately to review the state court decision might seriously erode federal policy." *Cox Broadcasting*, 420 U.S. at 483. Longstanding federal policy with roots in the Commerce and Due Process Clauses dictates that only the state of incorporation has the power to regulate a corporation's internal affairs and the corporation's relations with its directors and officers. California's recent attempts to erode this federal policy for the sake of its own policies has led to serious concern in the national business community that underscores the need for this Court's review.[2] *See* Brief of Amici Curiae, *supra*, at 15-19; *Directors' and Officers'*

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[2] This Petition is therefore readily distinguishable from the one considered in *Flynt v. Ohio*, 451 U.S. 619 (1981), cited by Respondent. *See* Opp. 17. In *Flynt*, resolution of the federal issue affected only the petitioners, who claimed that they had been subjected to selective and discriminatory prosecution. *Id.* at 620. The Court specifically held that there was no broader issue presented. *Id.* at 622.

Liability: Conflicting Regulation on Internal Affairs, N.Y. LAW JOURNAL, August 10, 2006, at 5 (noting that, in light of the Court of Appeal's decision, "[t]here is now an irreconcilable conflict between the courts of the nation's most populous state and those of the preeminent state of incorporation concerning the extent of California's authority to regulate the internal affairs of Delaware corporations—an issue of great legal and practical significance to the business community—and it is ripe for Supreme Court resolution").

The decision below presents cleanly the federal constitutional questions whether the Commerce and Due Process Clauses permit one State to regulate the internal affairs of another State's corporation. These issues will persist, and are independent of any state-law issues remaining to be resolved.

II. PETITIONERS PROPERLY PRESENTED THEIR FEDERAL CONSTITUTIONAL ARGUMENTS IN THE STATE COURTS BELOW

Contrary to Respondent's assertions, Opp. 18-20, the failure of the California Court of Appeal to address the federal constitutional issues that Petitioner raised in three separate state-court filings below does not preclude this Court's review.

First, Petitioners have already shown that they properly presented their constitutional arguments in the state courts. *See* Pet. 8-10. Contrary to Respondent's suggestion, *see* Opp. 18, Petitioners were not required to present federal constitutional issues in their notice of demurrers. Indeed, they could not do so under California law. *See* Cal. Civ. Proc. Code § 430.10 (specifying enumerated grounds for demurrer, including the only applicable ground, raised by Petitioners, that "[t]he pleading does not state facts sufficient to constitute a cause of action"). In their brief in support of their demurrers, Petitioners specifically noted that allowing a Delaware corporation to pursue claims under California law against its own officers and

directors for misuse of nonpublic corporate information would violate the Commerce and Due Process Clauses of the United States Constitution. Pet. App. 34a-35a (citing *CTS Corp. v. Dynamics Corp.*, 481 U.S. 69 (1987), and noting "*CTS Corp.* makes clear 'that the commerce clause mandates that a state apply the internal affairs doctrine'").

Second, Respondent ignores the fact that this case arises from the Superior Court's order ruling in Petitioners' *favor*—a result that required the state appellate courts, before reversing, to consider all grounds, including federal constitutional grounds, that could have supported the trial court's ruling. The trial court sustained demurrers to the first five causes of action "on the basis that Delaware law governs the relationship between Peregrine and its directors and/or officers." Pet. App. 29a. Although the Superior Court did not mention Petitioners' constitutional arguments in its brief order finding that Delaware law controlled, it was not required to do so. *See* Cal. Civ. Proc. Code § 472d. Indeed, because the Superior Court had concluded that Delaware law governed pursuant to California Corporations Code Section 2116 and the internal affairs doctrine, resolution of Petitioners' constitutional arguments was unnecessary. *See Mautner v. Peralta*, 215 Cal. App. 3d 796, 804 (1989).

Before any reversal of the trial court's ruling, the Court of Appeal was required to consider Petitioners' fully briefed constitutional arguments as alternative grounds supporting the trial court's order. Contrary to Respondent's statements, in reviewing the Superior Court's decision sustaining Petitioners' demurrers, the Court of Appeal was required under California law to look beyond the specific reasoning provided by the Superior Court. *See Weinstock v. Eissler*, 224 Cal. App. 2d 212, 225 (1964) ("Nowhere does [Section 472d] provide, as plaintiff would have it, that the order must be tested only according to the reasons given by the trial court. . . . [I]t is the validity of the court's *action*, and not of

the *reason* for its action which is reviewable." (emphasis in original)); *Mautner*, 215 Cal. App. 3d at 803 ("On review, we test the validity of the court's actions, not the reasons for its actions.").

Thus, as a matter of law, the Court of Appeal was required to consider any and all grounds supporting the demurrer—not just the ground relied upon by the trial court. *See Irwin v. City of Manhattan Beach*, 65 Cal. 2d 13, 20 (1966) ("If a complaint is insufficient on any ground properly specified in a demurrer, an order sustaining the demurrer must be upheld even though the particular ground upon which the court sustained it may be untenable."); *Gonzales v. State*, 68 Cal. App. 3d 621, 627 (1977) ("[S]ection 472d . . . has been interpreted . . . to require affirmance of a trial court's rulings on demurrers if any of the grounds raised by the defendant require the sustaining of the demurrer, whether or not the court specifies all the grounds."). Under California law, the Court of Appeal could not reverse the trial court's ruling without considering and addressing Petitioners' fully briefed arguments that any reversal would violate the federal Constitution. The Court of Appeal's failure to address the constitutional implications of its own ruling does not insulate those constitutional issues from this Court's review.[3]

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[3] *See, e.g., Supreme Council of the Royal Arcanum v. Green*, 237 U.S. 531, 537-41 (1915) (reviewing the application of New York law to a Massachusetts corporation as a violation of the Full Faith and Credit Clause even though the Clause was invoked only in a single paragraph of the answer and no New York state court ever discussed the Clause).

Respondent's reliance on *Street v. New York*, 394 U.S. 576 (1969), is unavailing, for in that case the Court concluded it had jurisdiction to review a federal constitutional issue that had been briefly raised at the trial court level, as here, even though the issue had not been addressed by the state appellate court. *Id.* at 581-84. Respondent's remaining authority is readily distinguishable. *Luri v. Greenwald*, 107 Cal. App. 4th 1119 (2003), did not address review of a demurrer ruling at all. *Id.* at 1124-25. And, unlike Petitioners, the appellant in *Duignan v. United States*, 274 U.S. 195

Petitioners' specific statement of the constitutional issues in the Superior Court briefing and full briefing of those issues in three separate filings in the appellate courts was more than sufficient for proper presentation to the state courts. The appellate court's federal constitutional error warrants this Court's review.

III. THE CALIFORNIA STATUTE VIOLATES THE COMMERCE AND DUE PROCESS CLAUSES

Contrary to Respondent's suggestion, Section 25502.5 is not a run-of-the-mill "insider trading" statute that protects California investors in California securities markets. It purports to govern claims by any foreign corporation, regardless whether it does any business at all in California, and affords such corporation treble damage claims against its own directors and officers if they are merely physically present in California when they made any decision to buy or sell stock, even if the actual purchase or sale occurred outside of California on a national exchange. *See* Cal. Corp. Code §§ 25502.5(a), 25008. Unlike California investors or officials, a Delaware corporation alleges not any injury to California markets, but rather a breach of official duty to the corporation, when it charges its own director with misuse of nonpublic information in connection with sales of the corporation's stock. Thus the issue in this case is quite narrow; it focuses solely on whether Section 25502.5, not Section 25402, violates the federal Commerce and Due Process Clauses as invoked by an out-of-state corporation.

Respondent ignores by lack of argument the three distinct ways in which Section 25502.5 violates the Commerce

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(1927), had abandoned any constitutional issues at the appellate court level. *Id.* at 200. Finally, the Court in *Ackermann v. United States*, 340 U.S. 193 (1950), was not even addressing the issue of proper presentation. *Id.* at 195, 197 (addressing question whether failure to file a timely appeal was excused under Rule 60).

Clause: reaching beyond California's borders to regulate claims by a Delaware corporation against its own directors and officers; directly regulating interstate purchases and sales of securities; and indirectly burdening interstate commerce with the risk of inconsistent regulation of directors' and officers' duties and liabilities to the corporations they serve. *See* Pet. 14-20; *see also* N.Y. LAW JOURNAL, *supra*, at 5.

Respondent instead seeks to avoid the force of these well-established principles by asserting that no intrusion on internal affairs is presented when directors are alleged to have *violated* their official duties. *See, e.g.*, Opp. 10, 20. This assertion is incorrect. *See* Restatement (Second) Conflict of Laws § 309 comment a ("Liability will typically be imposed upon directors under the [internal affairs doctrine] for such matters as the fraudulent or negligent mismanagement of the corporation's affairs, the unlawful declaration of dividends, the making of false returns, the unlawful acquisition of treasury stock and unlawfully profiting at the corporation's expense."). Misuse of inside information obtained in an official capacity is no less a breach of official duty than is "fraudulent or negligent mismanagement" or "unlawfully profiting at the corporation's expense." Contrary to Respondent's assertion, the claims here are squarely governed by the internal affairs doctrine.

Elsewhere, Respondent makes concessions that only highlight the Commerce Clause infirmity of applying Section 25502.5 to an out-of-state corporation. Respondent admits that California seeks to "deputize[]" corporations organized under the laws of other states as "private attorneys general" "to assist in deterring insider trading." Opp. 21. While California may deputize investors in its markets in such a role in a perceived effort to further California policies, it may not deputize an out-of-state corporation without intruding unconstitutionally into that corporation's internal affairs.

Respondent also concedes that a sister State has exclusive jurisdiction over such classic internal affairs of an out-of-state corporation as "the holding of directors' and shareholders' meetings." Opp. 9. Respondent conspicuously fails to mention, however, that Section 25502.5(c) intrudes squarely into that domain, purporting to set forth demand and quorum requirements for board meetings involving insider trading claims against the corporation's directors. This provision thus falls squarely within Respondent's own definition of a corporation's internal affairs, and nothing in the decision below suggests that this provision is severable from the rest of Section 25502.5.

Finally, in addressing Petitioners' Due Process challenge, Respondent ignores the fact that no California decision had previously allowed a foreign corporation to invoke Section 25502.5 at all, much less for so vague a reason as the "interests of justice." Petitioners were thus deprived of fair warning. Having consistently represented to Petitioners that their liability to the corporation would be governed by Delaware law, Peregrine should not now be permitted a bait and switch to California law with its unique treble damage remedy. For these reasons, this Court should review the decision below for inconsistency with the Due Process Clause.

Respectfully submitted,

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In The
Supreme Court of the United States

JOHN J. MOORES, et al.,

Petitioners,

v.

ROBERT C. FRIESE,

Respondent.

On Petition For A Writ Of Certiorari To The Supreme Court Of California

BRIEF OF AMICI CURIAE TECHNOLOGY NETWORK, CHAMBER OF COMMERCE OF THE UNITED STATES OF AMERICA, CALIFORNIA CHAMBER OF COMMERCE, NATIONAL ASSOCIATION OF MANUFACTURERS, CALIFORNIA MANUFACTURERS AND TECHNOLOGY ASSOCIATION, AND CALIFORNIA BUSINESS ROUNDTABLE IN SUPPORT OF PETITIONERS

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QUESTIONS PRESENTED

Whether, with respect to a claim of breach of official duty to a corporation, the Commerce Clause permits a State to substitute its own substantive law for that of the State of incorporation.

Whether the Due Process Clause permits the directors and officers of a corporation incorporated in one State to be sued under the substantive law of another State for alleged breach of official duty to the corporation.

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INTEREST OF *AMICI CURIAE*[1]

Technology Network ("TechNet") is a network of Chief Executive Officers and senior partners of more than 150 companies in the information technology, biotechnology, venture capital, investment banking and legal industries. The association is organized to promote the growth of the technology industry and the economy by building long-term relationships among technology leaders. As members and investors in the technology and biotechnology industries, TechNet's members represent the leading edge of developing, manufacturing, and marketing emerging technologies.

The question presented by this case – whether the federal Constitution permits California to regulate the relationship between a Delaware corporation and its own directors and officers – is an issue of recurring importance for members and investors in the emerging technology industries. The majority of TechNet's members lead companies capitalized through publicly traded shares. Many – including California icons like eBay, Genentech, Google, Intel, Oracle, and Yahoo! – are incorporated in Delaware. Companies choose to incorporate Delaware in part because of its well-developed, predictable corporate law. Companies and their officers, directors, shareholders and investors rely on knowledge that Delaware law will apply to their corporate affairs.

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[1] Counsel of record for all parties have consented to the filing of this brief and the consents are being filed with the Clerk of the Court simultaneously with this brief. Pursuant to this Court's Rule 37.6, *amici* state that no counsel for any party authored this brief in whole or in part, and no person or entity other than *amici*, their counsel and their members made a monetary contribution to the preparation or submission of the brief.

High-tech companies' stock prices are often volatile, as the market potential of their emerging technologies waxes and wanes. Due to this volatility, technology companies and their officers and directors are frequent targets of private securities litigation. Insider-trading claims, such as this suit, are especially common in the wake of a change in stock price. TechNet's members are affected directly by the decision of the court below to allow California law to create treble damage liability in favor of a Delaware corporation against its board members.

The Chamber of Commerce of the United States of America is the world's largest business federation, representing an underlying membership of more than three million companies and professional organizations of every size, in every industry sector, and from every region of the country. An important function of the Chamber is to represent the interests of its members in the courts on issues of vital concern to the nation's business community. Many Chamber members are incorporated in Delaware, but have their principal places of business in California (or elsewhere) and so are vitally affected by the decision below which undermines the internal affairs doctrine.

The California Chamber of Commerce is the largest voluntary business association within the State of California, with more than 15,000 members, both individual and corporate, representing virtually every economic interest in the state. The California Chamber acts on behalf of the business community to improve the state's economic and jobs climate by representing business on a broad range of legislative, regulatory and legal issues. The California Chamber participates as *amicus curiae* only on matters that have a significant impact on California businesses, such as this case.

The National Association of Manufacturers is the nation's largest industrial trade association, representing small and large manufacturers in every industrial sector and in all 50 states. The NAM's mission is to enhance the competitiveness of manufacturers by shaping a legislative and regulatory environment conducive to U.S. economic growth and to increase understanding among policymakers, the media and the general public about the vital role of manufacturing to America's economic future and living standards. Many of the NAM's members are incorporated in Delaware but have their principal places of business in California (or elsewhere), and so are vitally affected by the decision below.

The California Manufacturers & Technology Association is a non-profit corporation established to advocate for state laws and regulations that will enhance the business climate for California's 30,000 manufacturing, processing and technology-based companies. As part of its efforts, the CMTA seeks to develop and sustain consistent and predictable laws applicable to manufacturers and the broader business community. Many CMTA members are incorporated in other states but do significant business in California. For this reason, they are vitally concerned about the outcome of this case.

The California Business Roundtable is a nonpartisan organization composed of chief executives and senior officers of companies doing business in California. It represents virtually every major industry segment in the state. The Roundtable was created to permit senior business leaders to play an active role in the formulation and evaluation of public policy, and advocate for a strong economy and a healthy business climate in California. Many of its members are incorporated in other states,

often Delaware, but are headquartered or do significant business in California. They are vitally concerned about California's attempts to apply California law to internal affairs of Delaware corporations.

SUMMARY OF ARGUMENT

The Petition for a Writ of Certiorari presents a recurrent, important conflict concerning the federal constitutional limits on one State's power to regulate internal affairs of corporations incorporated in another State.

Following this Court's lead, Delaware courts have repeatedly held as a matter of federal constitutional law that a corporation's internal affairs must, except in rare cases, be governed exclusively by the law of the state of incorporation. *McDermott Inc. v. Lewis*, 531 A.2d 206 (Del. 1987); *Draper v. Gardner Defined Plan Trust*, 625 A.2d 859 (Del. 1993); *VantagePoint Venture Partners 1996 v. Examen, Inc.*, 871 A.2d 1108 (Del. 2005). In contrast, California has repeatedly tried to regulate internal affairs of corporations incorporated elsewhere (often Delaware), and California courts have repeatedly upheld such laws against constitutional challenge. *Western Air Lines, Inc. v. Sobieski*, 12 Cal. Rptr. 719 (Cal. Dist. Ct. App. 1961); *Wilson v. Louisiana-Pacific Resources, Inc.*, 187 Cal. Rptr. 852 (Cal. Ct. App. 1982); *Havlicek v. Coast-to-Coast Analytic Services, Inc.*, 46 Cal. Rptr. 2d 696 (Cal. Ct. App. 1995); Petition for Writ of Certiorari ("Pet.") App. A-E.

This conflict has deepened to the remarkable point of requiring the Delaware Supreme Court to hold a California statute unconstitutional. *See VantagePoint*, 871 A.2d 1108.

The conflict is exacerbated by the decision below. A Delaware corporation (Peregrine Systems, Inc., through its

litigation trustee, respondent Friese) seeks to hold its former directors (petitioners) liable for alleged misuse of corporate information for personal benefit. A director's or officer's liability to the corporation is generally an internal matter governed solely by the law of the state of incorporation – here Delaware. *See Shaffer v. Heitner*, 433 U.S. 186, 215 n.44 (1977); *Edgar v. MITE Corp.*, 457 U.S. 624, 645 (1982) ("matters peculiar to the relationships among or between the corporation and its current officers, directors, and shareholders" should be governed by law of state of incorporation); Restatement (Second) Conflict of Laws § 309 & cmt. a. Indeed, a director's or officer's relationship to the corporation cuts to the core of a corporation's internal affairs. The California court here nevertheless holds that California law applies to that relationship, and moreover subjects the directors to massive treble-damages liability that Delaware does not impose. As a result, directors and their corporations cannot predict which state's law will govern their responsibilities to each other or the consequences should they be deemed in breach.

Delaware's and California's conflicting views on the scope of the Commerce and Due Process Clauses are both entrenched, and only this Court can resolve the dispute. The Court should do so now. Healthy interstate commerce depends on predictable and stable legal rules. The particular issue here – California's attempt to intrude its law into the relationship between a Delaware corporation and its directors – is important in its own right given Delaware's prominence as the state of incorporation of half the nation's publicly traded businesses, and California's prominence as a center of business activity. Further, the dispute is not limited to the West Coast. New York, another critically important state, also purports to intrude its law into the relationship between directors and any foreign

corporation doing business in the state. *See* N.Y. Bus. Corp. Law §§ 1317(a), 719, 720.

Uncertainty over which state's law applies undermines the very interests that the Commerce Clause and Due Process Clause were meant to protect. It also takes away the very stability and predictability that corporations seek by incorporating in Delaware in the first place.

The Court should grant certiorari to resolve the conflict.

ARGUMENT

This Court has long recognized that "only one State should have the authority to regulate a corporation's internal affairs – matters peculiar to the relationships among or between the corporation and its current officers, directors, and shareholders – because otherwise a corporation could be faced with conflicting demands." *Edgar v. MITE Corp.*, 457 U.S. 624, 645 (1982). Of particular import here – where respondent seeks to hold a Delaware corporation's directors liable to the corporation under California law – "the law of the State of incorporation is held to govern the liabilities of officers or directors to the corporation." *Shaffer v. Heitner*, 433 U.S. 186, 215 n.44 (1977).

This rule is firmly grounded in practical reality. Directors' duties to their corporations need to be uniform. They also should not vary with the directors' respective residences or travels. Nor should directors be left to guess which states might assert authority. Our economy thrives when people can understand the rules applicable to their conduct, reliably foresee the consequences of their actions and promptly resolve any disputes related to their actions. The directors' duties to their corporation should therefore be resolved by the laws of a single state.

The decision below, however, disregards this principle, and exacerbates a continuing conflict between Delaware and California courts over the scope of two federal constitutional provisions.

First, the United States Constitution delegates to Congress the "Power . . . [t]o regulate Commerce . . . among the several States." U.S. Const. art. I, § 8, cl. 3. Under the dormant Commerce Clause, a state "has no interest in regulating the internal affairs of foreign corporations." *MITE*, 457 U.S. at 645-46. Application of "the law of the state of incorporation" alone to a corporation's internal affairs achieves "the need for certainty and predictability of result while generally protecting the justified expectations of parties with interests in the corporation." *First Nat'l City Bank v. Banco Para el Comercio Exterior de Cuba*, 462 U.S. 611, 621 (1983); *see also Shaffer*, 433 U.S. at 215 n.44 (internal affairs doctrine is based on "the need for a uniform and certain standard to govern the internal affairs of a corporation"). Our free market system "depends at its core upon the fact that a corporation – except in the rarest situations – is organized under, and governed by, the law of a single jurisdiction, traditionally the corporate law of the State of its incorporation." *CTS Corp. v. Dynamics Corp. of Am.*, 481 U.S. 69, 90 (1987).

In addition, the Fourteenth Amendment's Due Process Clause protects the right of every person to "fair notice" of both "the conduct that will subject [them] to punishment" and "also of the severity of the penalty." *BMW of N. Am., Inc. v. Gore*, 517 U.S. 559, 574 (1996). No less than others, a corporation's directors – and its officers, its stockholders and the corporation itself – are entitled to fair notice of

what law will govern their relationships and of the liabilities and the penalties that will attach to a violation.

Petitioners in substance ask the Court to take this case to decide whether the Commerce Clause and Due Process Clause allow a state to substitute its own substantive law, concerning a corporation's internal affairs, for that of the state of incorporation. As detailed below, the conflict between Delaware and California cases on this issue is real, and prompt resolution is important.

I. THE CONFLICT IS REAL AND PERSISTENT.

A. Delaware Cases Hold That a State Cannot Constitutionally Regulate Foreign Corporations' Internal Affairs.

The Delaware Supreme Court has laid down a clear, predictable rule. As a matter of federal constitutional law, and with only rare exceptions, the law of the place of incorporation exclusively governs a corporation's internal affairs.

In *McDermott Incorporated v. Lewis*, 531 A.2d 206 (Del. 1987), the Delaware Supreme Court held that a corporation's internal affairs must be governed by the law of its place of incorporation as a matter of federal constitutional law. At issue was whether a Delaware subsidiary, which owned shares in its Panamanian parent corporation, could take part in a vote of the parent's shareholders. The law of the place of incorporation, Panama, permitted subsidiaries to vote. *Id.* at 209-14. Delaware law prohibited subsidiaries from voting. *Id.* at 212. The Delaware Supreme Court held that Panamanian law must control under both the Fourteenth Amendment's Due Process Clause and the Commerce Clause.

As to Due Process, "directors and officers have a significant right, under the fourteenth amendment's due process clause, to know what law will be applied to their actions. Stockholders also have a right to know by what standards of accountability they may hold those managing the corporation's business and affairs." *Id.* at 216-17. Application of Delaware law "would unfairly and, in our opinion, unconstitutionally, subject those intimately involved with the management of the corporation to the laws of Delaware." *Id.* at 218.

As to the Commerce Clause, *McDermott* continued, this Court's decisions in *MITE*, 457 U.S. 624, and *CTS Corp. v. Dynamics Corp. of Am.*, 481 U.S. 69 (1987), established that a state "has no interest in regulating the internal affairs of foreign corporations" and that a corporation's internal affairs must "except in the rarest situations" be governed by "the corporate law of the state of its incorporation." *McDermott*, 531 A.2d at 217 (quoting *MITE* and *CTS*). "Since a state has no interest in regulating the internal affairs of a foreign corporation under *MITE*, Delaware has nothing left" to justify the burden on commerce from regulating a foreign corporation's internal affairs. *Id.* at 219. Application of Delaware law to a corporation incorporated in Panama would therefore violate the Commerce Clause. *Id.* at 218-19.

The Delaware Supreme Court reaffirmed this constitutional rule in *Draper v. Gardner Defined Plan Trust*, 625 A.2d 859 (Del. 1993). In a derivative action concerning a Delaware corporation, parallel litigation was pending in Delaware and California state courts. The Delaware trial court granted plaintiffs' voluntary motion to dismiss the Delaware suit in favor of the California suits. The Delaware Supreme Court affirmed, on the ground that

California would be constitutionally required to apply Delaware law. *Id.* at 864-65. Specifically, the court rejected defendants' prediction that if the Delaware suit were dismissed, the California courts would resolve the dispute under California rather than Delaware law governing a pre-suit demand on the board of directors. *Id.* at 864-69. Repeating that "application of the internal affairs doctrine is mandated by constitutional principles" under Due Process and the Commerce Clause "except in 'the rarest situations,'" the court could see "no reason" that California courts would refuse to apply Delaware law given "the vitality and constitutional underpinnings of the internal affairs doctrine." *Id.* at 866-68.

These holdings were further cemented in *Vantage-Point Venture Partners 1996 v. Examen, Inc.*, 871 A.2d 1108 (Del. 2005). The Delaware Supreme Court there held a California statute unconstitutional because it purported to regulate a Delaware corporation's internal affairs. Delaware law, together with the corporation's certificate of incorporation, mandated that a merger be authorized by all stockholders voting as a single class. *Id.* at 1111. California law, however, required that each class of shareholders vote separately. *Id.* at 1109-10 n.1. California Corporations Code section 2115 purported to impose this California requirement even on foreign corporations that had specified California contacts. *Id.*

The Delaware Supreme Court reaffirmed its established law that federal Due Process protected corporate actors' rights to know what standards would govern, and that the Commerce Clause negated any interest of one state in "regulating the internal affairs of foreign corporations." *Id.* at 1113 (citing *McDermott, MITE* and *CTS*). Among other things, uncertain application of another

state's law would "completely contravene[] the importance of stability within inter-corporate relationships that the United States Supreme Court recognized in *CTS*." *Id.* at 1115. It would also be "disruptive" for "different internal affairs rules to operate intermittently within corporation relationships under either the law of California or the law of the state of incorporation," depending on "the vi[ci]ssitudes of the ever-changing facts." *Id.* Therefore, the Court held, "the federal constitution mandated that Examen's internal affairs . . . be adjudicated exclusively in accordance with the law of its state of incorporation. . . . " *Id.* at 1116.

McDermott, Draper and *VantagePoint* represent entrenched, bright-line Delaware Supreme Court holdings that the Commerce and Due Process Clauses mandate that a corporation's internal affairs be governed only by the law of the state of incorporation. Applied to this case, the liability of petitioners to their Delaware corporation must be governed exclusively by Delaware law.

B. California Cases Hold That California May and Does Regulate Foreign Corporations' Internal Affairs.

In contrast, California courts have repeatedly upheld intrusion of California law into internal affairs of corporations incorporated in Delaware and elsewhere.

In *Western Air Lines, Inc. v. Sobieski*, 12 Cal. Rptr. 719 (Cal. Dist. Ct. App. 1961), the state of incorporation, Delaware, permitted a corporation to eliminate cumulative shareholder voting for its board of directors. Shareholder voting is a matter "peculiar to the relationships among or between the corporation and its . . . directors[] and shareholders," *MITE*, 457 U.S. at 645, and so within the

internal affairs doctrine. The California courts nevertheless held that the California Commissioner of Corporations may constitutionally bar a Delaware corporation from eliminating cumulative voting. Over the corporation's objection that the method of shareholder votes for the board of directors was an "internal affair" subject only to Delaware law, the California court held that California law properly applied to "corporate dealings with residents of this State." *W. Air Lines*, 12 Cal. Rptr. at 725, 727. It concluded that application of California law did not violate the federal Due Process, Full Faith and Credit, Equal Protection or Contract Clauses. *Id.* at 727.

Similarly, *Wilson v. Louisiana-Pacific Resources, Inc.*, 187 Cal. Rptr. 852 (Cal. Ct. App. 1982), upheld California's authority to regulate internal affairs of a foreign corporation. The corporate law of the state of incorporation, Utah, allowed the corporation to provide that shareholders' votes for the board of directors would be non-cumulative. *Id.* at 856. A California statute nevertheless provided that California corporate law applied because the corporation had specified California contacts. *Id.* at 854-55. California law required cumulative voting. *Id.* at 855. The California court, citing *Western Air Lines*, rejected all federal constitutional challenges to application of California's cumulative-voting requirement. It held that the "internal affairs doctrine" "has never been followed blindly in California" and is "not determinative of the constitutional issue." *Id.* at 858 (discussing full faith and credit). It rejected Commerce Clause and Due Process challenges to application of California law, holding that the burden on commerce was "incidental," application of California law was not "irrational," and the corporation had sufficient "contacts with California" to warrant application of California law. *Id.* at 858-62.

The California courts again upheld application of California law to an out-of-state corporation's internal affairs in *Havlicek v. Coast-to-Coast Analytic Services, Inc.*, 46 Cal. Rptr. 2d 696 (Cal. Ct. App. 1995). There the state of incorporation, Delaware, allowed directors to inspect corporate documents, but only for purposes reasonably related to the director's position as director. *Id.* at 699. California law authorized a director to inspect for any purpose. *Id.* The California court held that application of California's law did not violate the Commerce Clause. *Id.* at 701.

The decision below expands California's attempt to intrude its law into the internal affairs of foreign corporations. Peregrine Systems was incorporated in Delaware. Its articles of incorporation specified that Delaware law governed the scope of directors' liability to the corporation, and the articles eliminated directors' liability for monetary damages "to the fullest extent permissible under Delaware law." Pet. 6 n.2. The court below nevertheless ruled that the directors were subject to liability for treble damages under California Corporations Code section 25502.5. It did so despite clear arguments that such liability would, as the Delaware Supreme Court holds, violate the Commerce and Due Process Clauses. Pet. App. I 36a-44a.

So interpreted, Section 25502.5 unquestionably regulates foreign corporations' internal affairs. A director's or officer's liability to the corporation is a "matter peculiar to the relationship[] . . . between the corporation and its current . . . directors," *MITE*, 457 U.S. at 645, and so is normally an internal affair governed by the law of the state of incorporation. *See Shaffer*, 433 U.S. at 215 n.44; Restatement (Second) Conflict of Laws § 309 & cmt. a. Otherwise different directors would owe the corporation

different, possibly conflicting, duties, and directors' duties would change as they traveled from state to state. Section 25502.5 holds officers and directors liable to their corporations, and does so based on their positions *as officers and directors*. *See* Cal. Corp. Code § 25402 (barring, *inter alia*, "an officer, director or controlling person of an issuer" from buying or selling issuer's securities in California while in possession of material nonpublic information); § 25502.5(a) (issuing corporation may recover treble damages for violation of § 25402).[2] Application of section 25502.5 to hold respondent directors liable to their Delaware corporation is unconstitutional under the Delaware Supreme Court's construction of the Commerce and Due Process Clauses in *McDermott, Draper* and *VantagePoint*.

Nothing in the opinion below dispels this conflict. The court held that section 25502.5 fell outside the internal-affairs doctrine on the ground that it was enacted to deter insider trading, as part of California's corporate securities law. *See* Pet. App. E 12a-26a. But a constitutional *purpose* is not enough. California must use constitutional *means*.

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[2] In addition, section 25502.5 explicitly regulates the board of directors' quorum, voting and other requirements. If a shareholder demands that the corporation sue its directors, "the board [of directors] shall be required to consider the allegation in good faith," and a director accused of misconduct "may be counted in determining the presence of a quorum at a meeting of the board or a committee of the board" but, on matters related to the accusation, "shall not be entitled to vote." *Id.* § 25502.5(c). Standards and procedures for board of directors votes are normally internal affairs governed only by the law of the state of incorporation. *See MITE*, 457 U.S. at 645 ("matters peculiar to the relationships among or between the corporation and its current officers, directors, and shareholders" are subject to internal-affairs doctrine); *McDermott Inc. v. Lewis*, 531 A.2d 206, 218-19 (Del. 1987) (shareholder voting rights are internal affairs governed only by law of place of incorporation).

See, e.g., Bibb v. Navajo Freight Lines, Inc., 359 U.S. 520 (1959) (despite constitutionally permissible safety purpose, state law requiring mudguards on trucks impermissibly burdened interstate commerce and violated Commerce Clause). Under the Delaware Supreme Court's interpretation of the federal Constitution in *McDermott* and progeny, the means employed by California here are unconstitutional. Directors' liability to the corporation, as an internal affair, must be regulated solely by Delaware law.

In sum, whereas Delaware holds as a matter of federal constitutional law that a corporation's internal affairs are governed "exclusively in accordance with the law of its state of incorporation," *VantagePoint*, 871 A.2d at 1116, California holds that it may regulate internal affairs of Delaware corporations. The conflict is real, pervasive and entrenched. Only this Court can resolve it.

II. THE CONFLICT IS IMPORTANT AND SHOULD BE RESOLVED NOW.

Resolution of this conflict is important to businesses such as *amici's* members, which depend on predictability to manage their affairs. The holding below, giving a Delaware corporation a treble-damages claim against its own directors under California law, is particularly likely to inflict lasting damage if not promptly corrected.

To begin with, application of out-of-state law to a Delaware corporation's internal affairs affects an enormous number of corporations and a large sector of the nation's economy. Half of all U.S. publicly traded companies and 60% of Fortune 500 businesses are incorporated in Delaware. *See* State of Delaware, Division of Corporations, http://www.state.de.us/corp (visited August 9, 2006). Delaware is the state of incorporation of many businesses

whose principal places of business lie in other states, including many of *amici's* members. Pp. 1-4 above. Any of these corporations may have directors or officers who visit or live in California and buy or sell stock while in the state, subjecting them to a treble-damages cause of action by their corporation or those purporting to act for it.[3]

In addition, states other than California seek to impose their laws into the relationship between Delaware corporations and their directors. New York, for example, purports to regulate liability of directors of any out-of-state corporation doing business in New York. *See* N.Y. Bus. Corp. Law § 1317(a) (with specified exceptions, "the directors and officers of a foreign corporation doing business in this state are subject, to the same extent as directors and officers of a domestic corporation, to the provisions of" sections 719 and 720); § 719 (holding "directors . . . jointly and severally liable to the corporation" for specified acts as director); § 720 (authorizing causes of action against director and providing that action under sections 719 and 720 may be brought, *inter alia*, by the "corporation" or in shareholder derivative suit).

Thus two of the nation's most important economic powerhouses – New York and California – seek to impose their law on corporations incorporated in Delaware, the state of incorporation of half of the nation's large corporations. Delaware rejects their attempts. Directors and corporations are caught in the middle. They cannot predict whether Delaware's or some other state's law will govern.

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[3] Any insider who buys or sells a security "in this state," *i.e.* California, is subject to the insider-trading law, and so to section 25502.5. *See* Cal. Corp. Code § 25402 (barring insider trading "in this state"); § 25502.5 (treble-damages remedy for violation of § 25402).

Delaware, or California, or New York, or some other law may define each director's duties to the corporation, depending on where the director is and which state's court is interpreting the federal Constitution.

That uncertainty is intolerable. It strikes at the heart of the efficiency and predictability protected by the Commerce Clause and Due Process Clause in the first place, and indeed at the reason businesses incorporate in Delaware in the first place. "In corporation law, uncertainty about what the law is or what law is applicable to a given transaction constitutes a far more serious problem than in areas of the law which do not require comprehensive and continuous planning." Michael J. Halloran & Douglas L. Hammer, *Section 2115 of the New California General Corporation Law – The Application of California Corporation Law to Foreign Corporations*, 23 UCLA L. Rev. 1282, 1283 (1976).

Businesses *choose* to incorporate in Delaware largely to avoid such uncertainty. *See* Jonathan R. Macey & Geoffrey P. Miller, *Toward an Interest-Group Theory of Delaware Corporate Law*, 65 Tex. L. Rev. 469, 484 (1987) (businesses choose Delaware in part because of "greater predictability with respect to corporate legal affairs"); Rodman Ward Jr. & Erin Kelly, *Why Delaware Leads in the United States as a Corporate Domicile*, Del. Law., Fall 1991, at 15, 16 ("[O]ther states have a paucity of court opinions interpreting their corporate statutes, and, often, the judicial interpretations that do exist do not afford the same level of certainty and predictability to practitioners using their corporate codes."); William Jarblum & Bernard D. Bollinger, Jr., *Incorporation Issues: Why Delaware?*, Am. Bankr. Inst. J., Oct. 1999, at 6, 6 ("The corporation law of Delaware is widely regarded as the most extensive and well-defined body of corporate law in the United

States. . . . There is an anticipation that the Delaware General Corporation Law will continue to be interpreted and construed in significant court decisions, lending predictability to the corporate legal affairs of all corporations that are domiciled in Delaware."). The predictability that corporations seek, and promise to their directors, is eviscerated if other states can intrude their laws after the fact.

Nor should this Court wait to review the issue. The decision below, if not corrected, will have an immediate impact on the directors and officers whom it exposes to California law and on the out-of-state corporations whose internal affairs California attempts to regulate. Under California law, "Decisions of every division of the District Courts of Appeal are binding . . . upon all the superior courts of this state. . . ." *Auto Equity Sales, Inc. v. Superior Court*, 369 P.2d 937, 940 (Cal. 1962). California trial courts are thus required to follow an intermediate court of appeal decision such as the decision below. *Id.* Absent review by this Court, trial courts in California will be obliged by the decision below, when on point, to permit treble-damages claims by non-California corporations under section 25502.5 to proceed against their directors and officers.

Moreover, such claims in practice will be brought not at the corporation's election, but in derivative suits controlled by class-action lawyers. A § 25502.5 claim belongs to the corporation, but can be brought by a shareholder via a shareholder derivative suit. The 1995 Private Securities Litigation Reform Act imposed stricter pleading standards for private securities-fraud actions. *See* 15 U.S.C. § 78u-4. The Securities Litigation Uniform Standards Act of 1998 preempted many state securities-fraud suits – but exempted derivative claims. *See* 15 U.S.C. § 78bb(f)(5)(C). As

a result, shareholders bring investor fraud claims as derivative actions. The upshot is that the treble-damages liability to which California exposes foreign corporations' directors is not only potentially massive but unpredictable. It will impair many non-California corporations' ability to recruit and retain qualified directors.[4]

In short, the conflict between Delaware and California courts undermines the important federal interests in "certainty and predictability of result" and "protecting the justified expectations of parties" at the heart of the internal affairs doctrine. *First Nat'l City Bank*, 462 U.S. at 621; *see also Shaffer*, 433 U.S. at 215 n.44; p. 7 above; *Nagy v. Riblet Prods. Corp.*, 79 F.3d 572, 576 (7th Cir. 1996) ("A single rule for each corporation's internal affairs reduces uncertainty" and enables corporate actors to make choices, "confident that they can predict the legal effect.").

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[4] Experience teaches that the threat of massive damages will deter qualified directors from serving:

> In 1985, after the Delaware Supreme Court found the directors personally liable for deciding to accept a buyout offer in *Smith v. Van Gorkom*[, 488 A.2d 858 (Del. 1985)], the number of shareholder derivative suits brought for a breach of the duty of care dramatically increased. This, in turn, caused insurance rates for director and officer liability coverage to increase and, in some cases, corporations were unable to obtain insurance. Many directors, concerned about the prospect of being found personally liable for astronomical amounts, resigned their positions. Predictably, this has had an effect on corporations' ability to recruit qualified directors and officers.

Demetrios G. Kaouris, *Is Delaware Still a Haven for Incorporation?*, 20 Del. J. Corp. L. 965, 987 (1995) (citing Lynne A. Whited, Note, *Corporate Directors – An Endangered Species? A More Reasonable Standard for Director and Officer Liability in Illinois*, 1987 U. Ill. L. Rev. 495, 495-96, 504-05 (1987)).

CONCLUSION

For these reasons, *amici* respectfully urge the Court to grant certiorari.

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